
Michael J. Halloran

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THE PUBLIC DISPOSITION OF RESTRICTED SECURITIES AND OF SECURITIES HELD BY CONTROLLING PERSONS—THE WHEAT REPORT, SEC PROPOSED RULE 144 AND THE SEARCH FOR CERTAINTY*

MICHAEL J. HALLORAN**

In an attempt to eliminate uncertainty as to the application of statutory requirements to dispositions of restricted securities, and of unrestricted securities which are held by controlling persons, the Wheat Report¹ and the Securities and Exchange Commission have proposed rules designed to bring predictability into this area of the federal securities laws. "Restricted securities" means securities purchased from the issuer or a person controlling² the issuer in a so-called non-public or private offering.³

Persons (controlling or noncontrolling) who hold restricted securities and controlling persons who hold unrestricted securities may make resales to the public of their securities only if the securities are registered under the 1933 Act, or the securities are sold in a transaction exempt from such registration. The available exemptions are as follows: (1) the intrastate exemption of section 3(a)(11) of the Act;⁴ (2) the small

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** Member, California Bar. B.S., University of California (Berkeley), 1962; LL.B., University of California (Berkeley), 1965.
² This is a shorthand term for a "person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer," Securities Act of 1933, § 2(11), 15 U.S.C. § 77b(11) (1964).
³ Securities acquired from an issuer in a transaction exempt from registration by virtue of section 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1964)—"transactions by an issuer not involving a public offering"—are of necessity acquired in a non-public or private offering. Securities acquired from a controlling person in a transaction exempt from registration by virtue of section 4(1) of the Act—"transactions by any person [e.g., the controlling person] other than an issuer, underwriter, or dealer"—are also acquired in a non-public or private offering, through a rather tortured but long-honored line of reasoning, i.e., a controlling person, like any other person, is defined by section 2(11) to be an underwriter if he participates in an undertaking to sell securities for a controlling person with a view to distribution. If he sells his own securities he is certainly a participant in the undertaking to sell securities for a controlling person, namely, himself. The way to keep out of the definition of underwriter is to prove that there is no distribution. The word distribution is considered by the SEC to be synonymous with public offering. Quod erat demonstrandum.
offerings exemption provided by section 3(b) — Regulation A;5 (3) the
two exemptions designed primarily for exchanges of securities, sections
3(a)(9) and 3(a)(10);6 and (4) the exemptions most often used — those
found in sections 4(1) and 4(3) of the Act, which are not available to
anyone acting as an underwriter of securities.7 Considerable uncertainty
exists as to the precise definition of an underwriter. The rules proposed
by the Wheat Report, the rules proposed by the Commission on the
basis of that report8 and proposed rule 1449 are designed to give a more
certain definition to this term. Additional uncertainty arises from cer-
tain technical terms and concepts which have been developed in an
effort to impede the flow to the public of restricted securities and securi-
ties held by controlling persons, and the proposed rules attempt to
eliminate this uncertainty.

This article sets forth some of the major areas of uncertainty and
the Wheat Report's response thereto. The rule proposals of that report
and the 160 Series rule proposals of the Commission based upon the
Wheat Report are analyzed and some suggestions for improvement are
made. The sequel to the 160 Series, the Commission's proposed rule 144
is then analyzed in detail in an effort to learn from the few steps forward
and the numerous missteps and steps backward it has taken in the search
for certainty. The overall purpose of this article is to draw together in
one place the train of thought and learning in the search for predict-
ability with respect to the public disposition of restricted securities with
a view to guiding the Commission and interested persons toward the
adoption of a set of rules which will produce the desired certainty.

Areas of Uncertainty

The Nebulous Concepts of Investment Intent and Its Offspring: Holding Period and Change of Circumstances

A person who buys securities from an issuer or controlling person
will be an underwriter if he purchases the securities with a view to a
later distribution of the securities.10 How can an accurate assessment be
made of a person's view? This depends on his subjective intention or
state of mind at the time he bought the security. If he intended to
purchase the securities for immediate resale, then he purchased with a
view to distribution. If he purchased the securities with the intention

5 Id. § 77c(b).
6 Id. § 77c(a)(9),(10).
7 Id. § 77d(1),(3).
of holding them, he is said to have purchased them for investment, not for distribution. The question is whether one has an investment intent or a distribution intent.

"[S]tate of mind can ordinarily be ascertained only by weighing evidentiary factors, and . . . a person's actions may be of far greater evidentiary significance than his statements as throwing light on what his state of mind was at a given time." The holding period, that is, the length of time elapsing between the acquisition of securities and their proposed sale, was said by the General Counsel of the Commission to be undoubtedly among the most important evidentiary factors and if the securities have been held for a sufficiently lengthy period this "fact would be sufficient, if not contradicted by other evidence, to create a strong inference that they had been purchased for investment." What is a sufficient holding period to supply the evidence of investment intent? In 1938, the General Counsel opined that if the securities were retained for "as long as a year" that would create the "strong inference" of investment intent, absent contradictory evidence. In 1957, the Commission, obviously concerned with the increasing amount of securities of a speculative nature being sold to the public without registration, found that "holding for a year, does not afford a statutory basis for an exemption and therefore does not provide an adequate basis on which counsel may give opinions or businessmen rely in selling securities without registration." No definite holding period was set forth in this release. After further ambiguity on the subject some further light was

12 Id.
13 A related problem is the tacking of holding periods. This uncertainty arises in two contexts: (1) when there is an involuntary transfer from one person to another by operation of law, e.g., the termination of a trust, foreclosure by a pledgee, or death; and (2) voluntary exchange of one security for another by the investor, as in a business combination or upon conversion of a convertible security. Rule 155 of the General Rules and Regulations of the SEC under the Securities Act, 17 C.F.R. § 230.155 (1970), prevents the tacking of holding periods upon conversion of a convertible security. In other words, no matter how long the convertible is held, a new holding period commences at the time of conversion with respect to the security received on conversion. Following this concept to its logical extreme, rule 155 disallows the public sale of restricted convertible securities without registration; otherwise, the convertible security could be sold publicly without registration and the purchaser could convert it without regard to any rule against tacking.
16 The view is occasionally expressed that, solely by reason of continued holding of a security . . . for a year from the date of purchase, the security may be sold without registration. There is no statutory basis for such assumption. Of course, the longer the period of retention, the more persuasive would be the argument that the resale is not at variance with an original investment intent, but the length of time between acquisition and resale is merely one evidentiary fact to
shed when Commissioner (later Chairman) Manuel F. Cohen indicated that a holding period of more than two years would, with respect to a person who is not a professional, e.g., a securities dealer, and in the absence of other circumstances, permit sale of the securities free of registration.17

There are other indicators of a two-year holding period.18 However, it has become increasingly difficult to obtain no-action letters from staff members of the Commission if the holding period is just two years and there are no facts indicating change of circumstances.19 Probably as a result of the difficulty in obtaining no-action letters immediately after two years of holding, some authors now report the period may be two to three years.20

be considered. The weight to be accorded this evidentiary fact must of necessity, vary with the circumstances of each case.

SEC Securities Act Release No. 4552 (Nov. 6, 1962). If the holding period is "merely one evidentiary fact," does the Commission intend to reverse the statement by its General Counsel in 1938 that a sufficient holding period would establish a "strong inference" which, if not rebutted by other evidence, would establish investment intent? The Southern District in New York is of the opinion that a sufficient holding period, e.g., two years, "is an insuperable obstacle" to a finding of taking the securities with a view of distribution, in the absence of any relevant evidence to the contrary. United States v. Sherwood, 175 F. Supp. 480, 485 (S.D.N.Y. 1959). Perhaps this holding should be limited to criminal proceedings, particularly since the court noted at the conclusion of its opinion: "This decision is merely a finding that on this record the prosecution has not proven, beyond a reasonable doubt, that the accused's transactions were violative of the decree of this court [that the defendant could not sell his shares if a registration statement should then be required to be filed but not be filed]." Id. at 484.

17 SEC PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 31 (C. Israels ed. 1962) [hereinafter SEC PROBLEMS].
19 The author has recently encountered a case where a Commission staff member, in response to a letter from the issuer regarding proposed sales of formerly restricted shares by a noncontrolling person, wrote what can be regarded as an action letter, (a letter stating the staff would recommend action to the Commission if the sales were made without registration) in regard to a situation where the noncontrolling person (a former controlling person) had acquired the shares over two years and nine months earlier, and had suffered serious financial reverses in that time (he lost his job with the issuer and several of his bank borrowings, in connection with outside investments, were in default) amounting to a change in circumstances compelling him to sell his shares. Although the person had sold less than 20 percent of his shares in the two-year and nine-month period, the sales were all private placements. It is the author's view that the staff member's position is clearly erroneous. The uncertainty in this area prevents absolute assurance that the staff member is wrong. The value of a no-action letter is that a court will require the issuer to transfer the shares if one has been obtained. Kanton v. United States Plastics, Inc., 248 F. Supp. 353 (D.N.J. 1965); Petrillo v. Seven Arts Prods. Inc., CCH Fed. Sec. L. Rep. ¶ 91,921 (Sup. Ct. N.Y. County 1967). The weight behind an action letter is unclear; no court has ever considered the case. It is submitted that no weight should be attached to it, particularly in cases where the person involved has not had an adequate hearing before the Commission on the subject of the letter. See generally C. McCormick, HANDBOOK OF THE LAW OF EVIDENCE § 294 & n.8 (1954).
20 "As a practical matter, the shares may . . . be sold in any manner after the lapse of
It is submitted that the position of the Commission in this area (which has moved from a one-year holding period to two, and now perhaps more) whether expressed in no-action or action letters or in releases is possibly losing the respect to which it should be entitled in courts called upon to decide cases in this area. A recent case in New York fortifies the position that approximately a two-year holding period is sufficient.\(^{21}\) It should be remembered that the Commission’s pronouncements in this area have not yet amounted to rule-making (except with respect to rule 154 and certain other rules of a more specialized nature) and are not conclusive in civil or criminal litigation involving the sale of unregistered securities. The adoption of rules would do much to reestablish the Commission’s authority in this area, giving weight in courts to its pronouncements with the desirable side effect of lending certainty to a very uncertain area of the law.

Another evidentiary fact of investment intent is a change in circumstances. An unforeseen change of circumstances, which may involve the circumstances of the issuer or the investor;\(^ {22}\) between the date of purchase and resale may provide a basis for an opinion that the proposed resale is not inconsistent with investment intent.\(^ {23}\) An attorney rendering an opinion that restricted securities held by a noncontrolling person may be sold without registration will usually seek some change in circumstances which, taken together with the holding period, will support his opinion. The shorter the holding period (perhaps less than a year) the more severe and unexpected must be the change, \emph{e.g.}, death, serious illness requiring immediate funds to provide medical care, serious financial reverse caused by an unexpected event such as home or

\(\text{a sufficient amount of time, the period being rather indefinite but probably two to three years.}^{1}\) Schneider, \textit{Acquisitions under the Federal Securities Laws—A Program for Reform}, 116 U. Pa. L. Rev. 1323, 1337 (1968).

As a practical matter, holding the investment security for a three year period results in a presumption that the securities were originally taken for investment. Persons holding for two years have a fighting chance for a “no-action” letter if the other circumstances surrounding the transaction indicate an original “investment” intent. Since the Commission handles each case on an \textit{ad hoc} basis, no real rule of thumb is available.


\(^{21}\) In \textit{Leitman v. VTR, Inc.}, CCH Fed. Sec. L. Rep. \(\text{§} 92,707\) (S.D.N.Y. June 30, 1970), the shares were held for twenty-one months which, combined with changed circumstances (employment terminated, adverse financial conditions), was sufficient for the court to find that the shares were acquired with an investment intent. Consequently, an injunction was granted directing the defendants to permit transfer of the shares free of any restrictive legend on the certificates.


investment being destroyed by earthquake or fire. The longer the holding period (perhaps a year or two years), the less severe need be the change in circumstances, e.g., loss of job, demand by creditors for payments on loans not incurred in connection with the purchase of the securities and threat to declare default if not paid combined with shrinkage in assets of the debtor and inability to pay without resorting to sale of his securities, complete change in the nature of the issuer from a small company to a large conglomerate — in other words a change in the nature of the investment. After a certain period of time (perhaps two years plus) no change in circumstances or other evidentiary fact should be required to establish investment intent unless other facts which might be taken to indicate an absence of investment intent, such as a sale by the investment purchaser of a large percentage of his securities to a large number of persons, require more evidentiary facts on the investment intent side of the scale to permit sale of the securities without registration. The Commission has published its views as to some situations not involving change of circumstances, but has done little to aid in the search for what is a change in circumstances. The fact that it has not done so is understandable. As found by the Wheat Report, the change in circumstances test bears no relation to the needs of investors for adequate disclosure. Although the investor is broke, this does not seem to compel the conclusion that the public should not be protected. Recognizing this paradox, the Commission has not lent its weight to making the change in circumstances test more certain in application. A more pragmatic reason for this lies in the bifurcated nature of the Commission as an executive-prosecutorial body as well as a legislative rule-making body: the Division of Trading and Markets may prefer loose, uncertain standards to give it freedom of action in enjoining and prosecuting violations, while the Division of Corporation Finance would prefer certain rules of certain application in order to advise issuers, investors and their counsel as to application of the securities laws and thereby reduce the heavy volume of requests for no-action letters.

24 Thus, an advance or decline in market price or a change in the issuer’s operating results are normal investment risks and do not usually provide an acceptable basis for such claim of changed circumstances. Possible inability of the purchaser to pay off loans incurred in connection with the purchase of the stock would ordinarily not be deemed an unforeseeable change of circumstances. Id. The purchase of securities with the intention of retaining them only if the issuer continues to operate profitably is a purchase with a view to distribution. Thus, the court in Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), cert. denied, 361 U.S. 896 (1959), held there was no change in circumstances when Crowell-Collier failed to increase its advertising space as the investor had anticipated it would. Id. at 468.

25 THE WHEAT REPORT 168.

26 The Commission’s apparent reluctance to establish a fixed holding period after which restricted securities become unrestricted may be a result of the problems the Division
robust society does not desire a securities law which as interpreted is so uncertain that it “provides an unfortunate leeway for the unscrupulous” and a wide ambit for the exercise of a dragnet philosophy by the prosecutor.

Fungibility — Last-in-first-out or “worst-out”?

A surprising concept to the uninitiated, particularly because it is not set forth in any Commission rule or release, is the fungibility doctrine. This holds that when the investor makes a series of purchases of restricted securities of the same issuer or of restricted and unrestricted securities of the issuer it is impossible to distinguish the securities in an economic sense — the public sale of one is no different than the public sale of the other — so that arguably the holding period on all the securities should commence with the last purchase of restricted securities and all of the unrestricted should be deemed restricted as well. The logic in this area has not been overwhelming and has produced some ludicrous results.

The last-in-first-out theory of fungibility assumes that the investor is selling the securities acquired most recently. If an investor purchased unrestricted shares on the market and later purchased restricted shares in a private placement he could not publicly sell the unrestricted shares since it would be assumed he were selling the restricted shares in an economic sense; all of his shares are now restricted. If the investor purchased the restricted securities first and later the unrestricted shares it would be assumed at the time of subsequent public sale that he were...
selling the unrestricted securities; in this case the unrestricted securities would remain unrestricted. If restricted securities were acquired in a series of private placements it would be assumed at the time of subsequent public sale that the last acquired block of securities were being sold; the effect is to start the holding period on all of the securities from the date of the latest acquisition.\textsuperscript{30}

Most securities lawyers would agree that the Commission at one time applied the last-in-first-out theory of fungibility.\textsuperscript{31} Nonetheless, the Commission now takes the position that a security is fungible whether it came in first or last.\textsuperscript{32} Although this position probably makes more logical sense, it is the harshest application of the doctrine and has been dubbed the "worst-out" theory of fungibility.

Different lawyers have different attitudes about the doctrine. Many look to the probable purpose of the doctrine — to prevent a rolling distribution. This is accomplished by buying restricted or unrestricted securities, signing up a commitment to buy new restricted securities, and selling the older securities (which, if formerly restricted, have now been held for a sufficient holding period to be unrestricted) to raise money to buy the new restricted securities. This is the basis for the last-in-first-out formulation. Another example of a rolling distribution is buying restricted securities, pledging them for a loan to raise money partially to buy the restricted securities and partially to buy unrestricted securities on the market, then selling the unrestricted securities when the market goes up and pay off the loan. This is the basis for a first-in-

\textsuperscript{30}This is the Commission staff's position with respect to the receipt of contingent shares issued in an acquisition. See \textit{THE WHEAT REPORT} 173. Thus, where the parties to the acquisition cannot agree upon the number of shares to be issued, a commonly used compromise is to agree that if the earnings of the candidate in future years meet certain levels, additional shares, \textit{i.e.}, contingent shares, will be issued by the acquiring corporation to the former shareholders of the acquired corporation in those years. The compromise dies aborning when the shareholders of the acquired company learn of the fungibility doctrine. The ingenuity of securities' counsel comes to the rescue; he suggests that all of the shares which might be issued under the contingent formula be issued outright to the acquired corporation's shareholders and then placed by them in escrow to secure the future earnings performance. The holding period begins to run from the date of issuance, it would seem, since the purchasers are actually given all the rights of shareholders (they can vote, receive dividends, etc.) and have all of the investment risks (the issuer need not reacquire the shares, should future earnings levels not be met unless it wants to exercise its right to reacquire the shares, usually for a small price). Since the adoption of Accounting Principles Board Opinion No. 16, which disallows pooling of interests treatment for acquisitions involving contingent shares, this problem will arise less frequently. AICPA, APB Op. No. 16 (1970).


\textsuperscript{32}Id. 102 (remarks of Mr. Charles E. Shreve, Director, SEC Division of Corporation Finance).
first-out formulation of the doctrine. In both cases, the economic effect is that the public has supplied the money for the purchase of restricted securities. Following this theory, there are situations where the doctrine would not be applied. If a person owned a large block of shares of unrestricted securities and accepts a stock option for a few hundred shares, since no money is required to accept the option and very little is required to exercise it, it is not appropriate to apply the doctrine to the entire large block of shares which need not be sold to raise that small amount of money. It is believed that notwithstanding the “worst-out” official position of the Commission, as a practical matter fungibility is a factual matter. Where there is little possibility of a rolling distribution, a no-action letter can probably be obtained. But this is not certain.

The Group Concept of Person

Controlling persons and the brokers who sell the shares of controlling persons have had some difficulty with the word “person” as used in rule 133(d) and rule 154. In computing the 1 percent maximum sale permitted in any six-month period under those rules, only sales by the person making the sale are counted. However, the staff of the Commission construes the word “person” as if it said “persons” in any situation where the relationship among a group of persons is such as to indicate that they act in concert, that is, they act or might logically be expected to act as a syndicate in their sales.

This is another calculated attempt by the Commission to reduce the flow of unregistered securities to the public. The position of the Commission is quite justified where personal investment and sale decisions are made on a group basis or are controlled by one member of the group and such sales benefit the members of the group. A father and

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33 With the advent of the publication by the Commission of its responses to requests for no-action letters, its true position in this area is becoming known. See, e.g., In re Mark Systems, Inc., CCH Fed. Sec. L. Rep. ¶ 77,979 (Jan. 10, 1971) where the Commission noted that the fungibility concept would not be applied in the case of receipt of warrants subsequent to the original purchase of shares, when the warrants are issued in consideration of the purchaser's undertaking to purchase collateral pledged by the issuer with a bank should it default on a loan. See also In re Neotec Corp., CCH Fed. Sec. L. Rep. ¶ 77,976 (Jan. 18, 1971).

34 17 C.F.R. §§ 220.133(d), 280.154 (1970); SEC PROBLEMS 115 (remarks of Mr. Cohen).

35 These rules permit a controlling person to make casual sales within certain limitations if his shares are unrestricted. In the absence of these rules, the controlling person would be treated as if he held restricted securities with a perpetual holding period. The rules are designed to permit leakage of a limited amount of securities within a six-month period, but not successive six-month periods—(see note 41 and accompanying text infra), in ordinary trading transactions with minimal or no selling effort. They are calculated to permit a controlling person to realize somewhat on his investment.
his minor children for whom he is acting as custodian should not each be permitted to sell up to 1 percent; their sales are generally deemed sales by one person since the proceeds of sales undoubtedly benefit the entire group and sales are made in concert for the benefit of the group. Relatives living in the same home may generally be included in the same group as would sales by a group of persons who act in tandem or in concert with respect to their sales, e.g., when the persons are partners in a business and make investments with partnership money. This concept of person has been summarized by the Commission in releases regarding rule 154 as "a group of closely related persons." Nonetheless, like all uncertain concepts it has a tendency to expand. Although most securities lawyers would agree that all members of a controlling group of an issuer would not be considered "a group of closely related persons," a recent case seems to imply that the concept extends to all members of a control group. It is submitted that this case is not correct and is inconsistent with the Commission pronouncements on the subject and the purposes of rules 133(d) and 154. Rule-making by the Commission is needed to clear up this area of law.

36 SEC Securities Act Release Nos. 4669 (Feb. 17, 1964) and 4818 (Jan. 21, 1966). As will be seen, the expansion of the person concept in rule 144 beyond the group of closely related persons creates insuperable problems for the seller and his broker and brings an unacceptable degree of uncertainty to this area of securities law. See note 93 and accompanying text infra.

37 If the Commission had wanted to use the concept of controlling group in the cited releases it would have done so since the concept is not without substance, having been construed in several proceedings before the Commission and the courts. At a joint ALI-ABA Conference on Governmental Regulation at the University of Wisconsin Law School in August 1966, Charles Shreve, then Director of the Division of Corporation Finance of the SEC, went to great pains to disabuse members of the bar of the idea that a "group of closely related persons" meant a control group. The examples given in the text are those given by him at that conference. Mr. Shreve summarized his position as follows: where the persons have a close relationship, either family or business, amounting to a "community of interest" between, or concerted action by the persons, it is probable that they are to be considered the same person for purposes of the 1 percent limitation on sales by that person in rules 133(d) and 154.

38 Strathmore Sec., Inc., SEC Securities Exchange Act Release No. 8207 (Dec. 13, 1967), discussed in PLI TRANSCRIPT No. 11,115. The SEC first found that nineteen stockholders were members of a control group dominated by one person and found that their combined sales exceeded the 1 percent leakage provision of rule 153(d). The Commission does seem to approach the "community of interest" or acting in concert concepts: "Perma was a small corporation and most of its 19 stockholders were united by family, personal or business ties and acted in concert with or acquiesced in the actions of [the senior executive] as their leader." Id.

39 See PLI TRANSCRIPT No. 11,116. Although the Strathmore case seems to approach the "community of interest" or acting in concert concepts, the nineteen shareholders did not make their personal investment decisions as to sales of stock as a group or on the basis of the decision of the senior executive, nor did such sales benefit all members of the group. The concept of controlling group is much broader than the person concept because it has to do with control of the management and policies of a corporation (see rule 405, 17 C.F.R. § 230.405 (1970)) not with personal investment decisions.

The group of persons in Strathmore apparently controlled the management and
Successive Six-Month Sales

How often may rule 133(d) and rule 154 be used by controlling persons or brokers selling for them? The rules would seem by their terms to permit their use every six months. In 1964, the Commission confirmed, in writing, what had been its informal interpretation of rule 154, namely, that if a plan exists to effect a series of sales every six months, this is not the ordinary trading permitted a controlling person by the rule but is a distribution beyond the confines of the rule. A plan is another matter of subjective intention which in turn must be demonstrated by objective evidentiary facts. Can an attorney advise his client to use rule 154 twice in succession? Three times in succession? Twice in succession, skip one six-month period, and then once again? Varying advice is given by securities attorneys on this question.

The summary above is by no means a catalogue of all the uncertainties in the area of disposition of restricted securities. However, these are the major uncertain areas that the Wheat Report, the 160 Series and proposed rule 144 attempt to solve.

The Wheat Report and the 160 Series

The Wheat Report recognized that solutions to the uncertain areas must be made by rules which are responsive to the purpose of the 1933 Act, which is “[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce . . . and to prevent policies of the corporation and were therefore members of a control group. Since the purpose of rule 133(d) and rule 154 is to allow leakage of a small amount of securities by individual controlling persons so that they will not be locked-in forever and may realize to some extent on their investment, the concept of person should be limited to those who jointly make a sale decision and those who receive the direct benefit of leakage sales.

It is interesting to note that the Commission applies the group concept of person when it is concerned about limiting the flow of unregistered securities to the public without the disclosures that would be made in a statutory prospectus. Rule 254, 17 C.F.R. § 230.254 (1970), provides that a person other than the issuer may offer up to $100,000 of securities under Regulation A. Since sales under Regulation A are accompanied or preceded by an offering circular which has been reviewed by an SEC regional office, the Commission will allow any number of persons, related or unrelated, whether they act in concert or in tandem, each to sell up to $100,000 under Regulation A. (Based on informal advice given to the author by Arthur Pennekamp, Director of the San Francisco Regional Office of the SEC.)


The elusive concept of control and “transaction not involving a public offering” are two major uncertain areas which deserve clarification by Commission rule-making. See THE WHEAT REPORT 156-59. With respect to the second concept, it is suggested that the solution may be in a rule which requires (1) a legend on the shares as a condition to using the rule to establish a valid private offering, cf. id. at 219, (2) certain numerical tests and (3) certain types of close relationships to the issuer or business sophistication. See, e.g., CAL. ADMIN. CODE § 260.102.2 (1969), 1 BLUE SKY L. REP. ¶ 8,514 (Feb. 18, 1971).
frauds in the sale thereof. . . . The proposed rules were designed with an eye on the admonition of Mr. Justice Clark that "[t]he focus of inquiry should be on the need of the offerees for the protections afforded by registration." In determining the need of offerees for protection, and the amount of statutory disclosure, i.e., 1933 Act registration, required in any given situation, three themes pervade the Wheat Report in this area: (1) where the issuer is providing information concerning its business and financial affairs in regular reports to the Commission under the Securities Exchange Act of 1934 (as embellished by the Wheat Report), (2) where the quantity of securities being sold is "modest" rather than "massive" and (3) where there is not a heavily compensated selling effort in selling the securities to the public but rather the securities are sold in ordinary brokers' transactions at standard brokerage commissions with no underwriting or stabilizing effort, then the need for 1933 Act disclosure and the protections afforded by registration is less. Accordingly, the rules proposed by the Wheat Report permit unrestricted (held by controlling persons) and restricted (held by controlling or noncontrolling persons) securities of reporting companies to be sold to the public in rule 154-type transactions, i.e., 1 percent sales if there are no solicitation of orders to buy by the broker and the broker receives only the minimum commission permitted on a national securities exchange. Heretofore, rule 154 has been limited to controlling persons holding unrestricted securities. The Wheat Report placed controlling persons and noncontrolling holders of restricted securities (and brokers selling on their behalf) on the same footing under one rule as far as casual sales are concerned. The peculiar situation of giving controlling persons the right to make rule 154-type casual sales while denying non-controlling investment purchasers any leakage at all would be eliminated.

One of the important findings of the Wheat Report in this area

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43 Securities Act of 1933, preamble. See also The Wheat Report 178.
45 The Wheat Report ch. VI, especially 156 & 189.
46 Id. app. VI-1. Although not articulated in the report itself, a pragmatic reason for permitting such sales in the absence of registration is that a shelf registration is of little utility because of difficulties in keeping the prospectus current and distributing the most current prospectus to the ultimate purchaser and because of other problems with such registrations. See Current Problems of Securities Underwriters and Dealers, in Selected Articles on Federal Securities Law 31, 62-64 (H. Wander & W. Grienenberger eds. 1968). The rules do not cover non-public sales which, of course, may be made without registration.
47 The Wheat Report 181, 185. Any securities' attorney who has had to explain this anomalous situation to his client is cautioned to read the late W. McNeil Kennedy's play, The Case of The Scarlet Letter, 23 Bus. Law. 23 (1967). The client finally jumps out of the office window to provide the required change in circumstances.
is that the change of circumstances doctrine and the holding period requirement are essentially nonfunctional in the context of the Act in that they bear no relation to the needs of investors for adequate disclosure, because as soon as the required holding period, coupled with change of circumstances, if necessary, has been met, the seller may engage in a very substantial selling effort (paying whatever underwriting discount he wishes) to sell a massive amount of his securities without any disclosure whatsoever. The report would completely eliminate the change of circumstances doctrine. As to the holding period, the report admitted that the purpose of the Act would logically dictate that restricted securities could never be sold to the public without registration. In other words, there would be no particular holding period, but rather an indefinite holding period. The Study concluded that “[p]erpetual restraints on alienation have been viewed with disfavor and would create difficulties in the administration of the Act.” The report fixed a five-year holding period after which restricted securities become unrestricted if the issuer meets a $250,000 annual gross revenues test designed to give assurance it is a going business and not a shell corporation. It is submitted that there is an additional, perhaps more meaningful, reason why restricted securities cannot be restricted indefinitely. Neither the legislative history, nor the wording of the 1933 Act indicates an intention to severely reduce the flow of venture capital into business enterprises, which might be the result of such a construction. The concept that securities might be sold in a non-public offering did not encompass the idea that the purchasers could never sell the securities without registration. If this had been the idea, the complex definition of underwriter in section 2(11) of the Act would be unnecessary — it would have been a simple matter to draft section 4(1) to read: “transactions by any person other than an issuer, dealer, controlling person, or person who acquired the securities in a transaction referred to in section 4(2).” The Act contemplates that after some period of time a person ought to be able to establish he is not an underwriter. Restricted securities of reporting companies would be subjected to a one-year holding period before they could be sold under the 1 percent limitations of the Wheat Report rules. The purpose of this holding period is to prevent “[t]he use of ostensible private purchasers as conduits for the sale of securities [by the issuer] to the public.”

49 Id. 188. See note 26 and accompanying text supra; notes 78-82 infra.
50 The Wheat Report 189, 244.
51 See note 87 and accompanying text infra.
52 The Wheat Report 199.
securities of non-reporting companies could not be sold under the rules and would have to await the five-year holding period before they could be sold. It is at this point that there was a justifiable parting of the ways between the recommendations of the Study and the ideas of the Commission. 53

As to unrestricted shares held by controlling persons, the Wheat Report would leave the law substantially unchanged: a controlling person who acquires his shares in the trading market is not subject to a particular holding period as such, but can only sell his securities to the public within the 1 percent leakage limits permitted by the proposed rules; 54 the net effect is that the controlling person has an indefinite holding period.

The Wheat Report 55 and the Commission 56 agree that the concept of fungibility "bears little relationship to the needs of investors for disclosure" and, accordingly, the fungibility concept was thought to be eliminated in the Wheat Report rules and in proposed rule 144 with one limited exception designed to prevent rolling distributions, i.e., the holder shall not have purchased any additional restricted securities of the same issuer during the one-year (eighteen months in the case of rule 144) holding period. 57 Notwithstanding the statements that the fungibility concept has been abandoned, it has been preserved in rule 162(b)(3)(E) proposed by the Wheat Report, rule 162(a)(4) of the 160 Series and proposed rule 144(a)(2)(A). In determining the amount of securities which may be sold, one must take into account "all other sales of the same class within the preceding six [rule 144 — twelve] months by or on behalf of the same offeror [rule 144 — the person and his associates]." This would include sales of unrestricted securities in the open market. The Wheat Report stated that "[p]urchases of securities of the same class in the open market, and sales, either of restricted or unrestricted securities, should not affect the period of holding." 58 The fact is that sales of unrestricted securities acquired in the open market do affect the period of holding of restricted securities because to the extent that they use up the 1 percent limit they require the restricted securities to be held for another six months. This is fungibility in reverse. It is submitted that the rules should restrict resale of restricted

53 See note 75 and accompanying text infra.
54 He can, of course, sell in a private placement and sell to the public under 3(a)(11) or Regulation A or can register his securities. See THE WHEAT REPORT 199 n.45, 228.
55 Id. 174.
57 THE WHEAT REPORT 201, 280-32; proposed rule 144(a)(1)(c).
58 THE WHEAT REPORT 201; see also id. 199 n.45 & 281.
securities by noncontrolling persons only by reference to prior sales of restricted securities in order to prevent rolling distributions through successive sales of restricted securities. To accomplish this result it is recommended that securities not acquired in a "transaction not involving a public offering."\(^{59}\) should be disregarded for purposes of the cited rules and excepted from them.

As to the contingent stock situation,\(^{60}\) the *Wheat Report* rules provide that the additional contingent shares are deemed to have been purchased at the time of the original sale of the assets to the issuer, provided that the sale took place at least one year prior to the receipt of the shares and no additional payment of money or property was made. In other words, contingent stock is treated just as if it were a stock split or stock dividend—the holding period of the stock originally acquired is tacked to the newly received contingent shares.

As to the tacking of holding periods, the *Wheat Report* rules would eliminate tacking questions in connection with stock dividends, stock splits, recapitalizations, securities transferred on death or as gifts, certain business combinations, termination of trusts, foreclosure by a pledgee and securities acquired on conversion and, with certain modifications, would tack the holding periods of securities received in such transactions with the holding periods of securities already held or exchanged in such transactions.\(^{61}\) Rule 155 would be repealed.\(^{62}\)

The group concept of person would be limited to members of a carefully defined family group living in the same home.\(^{63}\) A definition of offeror was embodied in the report's rule 162; the definition is close to the definition of associate in rule 405.\(^{64}\) The persons encompassed in this definition are those with a close "community of interest" whose sales are most likely to be made in concert. It is true that there are possibly other situations where persons have a "community of interest" and act in concert.\(^{65}\) The uncertainty which would be created in trying to cover these situations seems to call for a more restrictive definition such as that adopted by the Study. Having provided that only securities of

\(^{59}\) The following language would be even better: "in a transaction claimed to be exempt from registration by reason of section 4(2) of the Act."

\(^{60}\) See note 30 supra; *The Wheat Report* app. VI-1, rule 162(c)(1).

\(^{61}\) *The Wheat Report* 201, 238-43.

\(^{62}\) Id. 236-38.

\(^{63}\) Id. 196.

\(^{64}\) 17 C.F.R. § 230.405 (1970). Offeror is less broad than associate because it requires that an associated corporation be controlled by the person, whereas rule 405 requires only that he be an officer, partner or 10 percent security holder. This is justified because of the "community of interest" idea behind the person concept. See note 37 supra.

\(^{65}\) E.g., partners making investments in tandem. See note 36 and accompanying text supra.
reporting companies may be sold under the rule, there is not the compelling need to structure a rule which will cover all "community of interest" situations. The limitation on successive six-month sales would be dropped.68

There is one serious technical defect in proposed rule 161(a) which is repeated in proposed rule 144(a). The wording begs the question by providing that the rule is applicable to securities acquired by a person "in a transaction not involving a public offering." This could possibly be construed to produce a "ping-pong" effect: You are entitled to use the rule only if you establish you acquired your securities in a private offering in the first place. A sale believed to be made pursuant to the rule could in fact be a violation of the 1933 Act if the private offering exemption were not available in connection with the original acquisition of the securities sold to you. The certainty to be provided by the rule would be lost if the person using it is required to prove that he acquired his securities in a valid private offering. It had been one of the purposes of the Wheat Report to establish objective tests which would make such proof unnecessary.67 The person making the offer pursuant to the rule and his broker will frequently be unable to verify the non-public nature of the original transaction. This is particularly so where the person making the sale acquired his shares from another person who did not acquire his shares in a valid private offering. The problem can be solved by qualifying the language to read "in a transaction claimed to be exempt from registration by reason of section 4(2) of the Act, whether or not the transaction was exempt from registration, unless the offeror has actual knowledge that the transaction was not so exempt."68

68 The Wheat Report 196. Since this limitation was never contained in a Commission rule, the method chosen to drop it was to announce that sales limited as described in the rules could be made in successive six-month periods without violations of the rule. 160 Series at 7.

67 The Wheat Report 152, 204-05. Rule 161(c) of the 160 Series solves only one example of this problem: where some person other than the person using the rule makes a public offering of securities acquired in the same transaction as the person using the rule, thus making a public offering out of a former private-offering transaction. It does not solve the problem of actions by the issuer or of inadvertent actions by the person using the rule, i.e., several statements or actions indicating lack of investment intent, which destroy the private offering. Proposed rule 144 does not even contain a provision comparable to proposed rule 161(c).

68 Such a proposal would not relieve the issuer, controlling person or any person who sold the security in violation of section 5 from liability under sections 12 and 17 of the Act, thus inhibiting invalid private placements with the intention of distributing the securities by means of the rule. 15 U.S.C. §§ 77c, 77l, 77g (1964). The proposal properly relieves the innocent offeror of liability for acts of which he has no knowledge, and places the holding of Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), cert. denied, 361 U.S. 896
Another technical defect is contained in proposed rule 162(c)(1) which is repeated in proposed rule 144(a)(1)(D)(i). These provisions attempt to allow tacking of the holding periods with respect to stock dividends, stock splits and recapitalizations. Logic would require that the holding period of shares acquired as stock dividend date back to the date the original investment was made. However, later successive stock dividends do not seem to date back to the original investment under the proposed rules but rather date back to the preceding stock dividend ("the shares on which the dividend was paid"). If an issuer declares an annual stock dividend the holder may not be able to dispose of his shares because of the holding period requirement.

In various situations it is difficult to determine when the entire consideration for securities has been paid. As a result, proposed rule 162(c)(1) and proposed rule 144(a)(1)(B), which both require the full purchase price to have been paid at least twelve (eighteen) months prior to the offering, are difficult to interpret. For example, if there is an installment purchase of shares by payment of a promissory note due in installments, has the full purchase price been paid upon original delivery of the note,\(^6\) as to the proportion of the aggregate amount of securities acquired as each note installment is paid, or upon payment of the last installment on the note? The problem is more difficult when the consideration is less tangible. Suppose an employee is issued securities in consideration for entering into a long-term employment agreement; add to this the situation where the securities may be reacquired by the issuer on a decreasing percentage basis if employment is prematurely terminated. Rule 162 specifically dealt with the similar problem of a contingent stock acquisition, but the requirement that no additional payment of money or property be made after the original acquisitions would indicate the answer to the installment note purchase example above is that the holding period begins to run on the last payment on the note. Counsel for venture capitalists would be well advised to insist on a series of separate cash purchases rather than on installment purchase of a block of stock.

\(^{69}\) For purposes of a corporations law requiring payment in money or property for shares, a promissory note is considered by some courts to be full payment. See, e.g., Quartz Glass & Mfg. Co. v. Joyce, 27 Cal. App. 523, 150 P. 648 (Dist. Ct. App. 1915).
The 160 Series

Six months after the Wheat Report was published, the Commission published for comment a series of rules based on the rules proposed by that report. The proposed rules were almost identical to those proposed by the Wheat Report discussed above, but were different in certain material respects which are set forth below.

The annual gross revenues requirement was changed from four years of $250,000 of annual gross revenues to five years. Since the holding period is five years, the obvious purpose of a four-year period had been to give a one-year grace period to a start-up enterprise. The effect of extending the annual gross revenues requirement for an additional year is an extension of the holding period to six years for most beginning enterprises, whose annual gross revenues in the first year of operation are very often nominal. Since the SEC later became concerned that the annual gross revenues requirement was unduly restrictive and might adversely affect the ability of small companies to raise capital, it is difficult to understand why the Commission lengthened the period of the annual gross revenues requirement.

A new rule 161(c) was proposed in order to reduce the burden imposed upon the person using the rule of having to prove that the shares were acquired in a transaction not involving a public offering. Rule 161(c) provides that a restricted security remains such, i.e., it remains within the confines of the 160 Series rules, notwithstanding the fact that another person makes a public offering of securities acquired in the transaction or chain of transactions in which the securities subject to the 160 Series was acquired.

In order to reduce manpower requirements, the list of qualified issuers, i.e., reporting companies, proposed by the Wheat Report to be maintained by the Commission was dropped and an objective definition of qualified issuer was proposed in rule 163. It is not immediately apparent why the Commission believes that it will incur significant manpower problems in maintaining a list of qualified issuers when it presently maintains a restricted list of Canadian issues which are being illegally sold in the United States.

Rule 162(c)(1) proposed by the Wheat Report contained a provision which excepted stock purchased on exercise of qualified stock

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70 160 Series, rule 161(b); cf. THE WHEAT REPORT app. VI-1, rule 161(c).
71 See note 75 and accompanying text infra.
72 See note 67 and accompanying text supra.
73 See note 82 and accompanying text infra for discussion of solutions to the manpower problem.
options and under qualified employee stock purchase plans from the limited one-year fungibility requirement designed to prevent rolling distributions. This was omitted from rule 162(c)(1) of the 160 Series without comment or explanation by the Commission.\textsuperscript{74}

In a slight retreat to the fungibility doctrine, rule 162(c)(2) was revised to provide that if any part of an interest in a business transferred in exchange for restricted securities had been acquired by the offeror within one year prior to his acquisition of the restricted securities, the holding period with respect to the restricted securities would begin on the date of the latest acquisition of such part or parts of the interest. The \textit{Wheat Report} rule had broken with the fungibility concept in this regard and had provided that the separate part or parts of the interest are to be treated separately, and the holding requirement as to an equivalent proportion of the restricted securities shall be deemed satisfied one year after the acquisition of each such part. Again, no reason was given in the release for this partial retreat to the fungibility doctrine.

These are essentially all of the substantive changes made by the 160 Series from the \textit{Wheat Report}. To the extent the changes may be regarded as adverse, they are certainly not substantial and the Commission's proposals are substantially the same as the \textit{Wheat Report} proposals. It had been hoped by many that the search for certainty had ended and that the proposals would be adopted in short course. However, this was not to be the case.

\textbf{Proposed Rule 144}

\textit{Commission Objections to the 160 Series—Steps Forward}

Rule 144 was proposed by the Commission as an alternative to the 160 Series.\textsuperscript{75} The Commission had three objections to the \textit{Wheat Report} proposals: (1) the "holding period of one year is too short and would result in the sale of large amounts of unregistered securities to the public"; (2) the requirement that restricted securities of nonreporting companies could not be sold at all unless the issuer "had substantial annual gross revenues for each of the past five years" is "unduly restrictive and would adversely affect the ability of small companies to raise capital."; (3) the Commission does not have sufficient manpower to maintain a list of qualified issuers or to examine 1934 Act filings to assure they meet the applicable requirements; and (4) the concept of qualified issuer combined with the annual gross revenues test might

\textsuperscript{74} See note 103 and accompanying text infra.

"give the impression that the Commission is permitting the sale of securities on the basis of their investment merit."

All of these objections except the last are well taken. Each objection can be answered by appropriate amendments to the 160 Series or other rules without adopting a new rule, such as rule 144, which produces more uncertainties and raises more objections than it answers. As to the holding period, the Wheat Report recognized that views as to the appropriate length differed appreciably; if the eighteen-month holding period in rule 144(a)(1)(A) is the price for obtaining certainty, then change the one-year holding period in the 160 Series to eighteen months. As to the annual gross revenues requirement, the Commission is to be complimented for its recognition of the importance of venture capital investments in small business in the United States. The purpose of the $250,000 five-year annual gross revenue requirement was to prevent circumvention of the rules by setting up shell corporations having no operations and holding their securities on the shelf for five years. The Commission's solution to the annual gross revenue re-

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76 Id.
77 THE WHEAT REPORT 200. Some persons had strongly urged that the holding period should be two years. Eighteen months is an obvious and acceptable compromise by the Commission.
78 The author is aware of several venture capital situations in which the maturation period — the period during which the business is expected to show little revenues because of a lengthy research and development period — is three to five years. To require the venture capitalist to either go through the expense of registration or to hold his shares for a total of eight to ten years before the company meets the five-year annual gross revenues requirement seems restrictive. The amount of tinkering with the annual gross revenues requirement indicates that there is considerable controversy inside the Commission regarding it. See note 70 and accompanying text supra.
79 See notes 26, 50 and accompanying text supra; THE WHEAT REPORT 203. It is submitted that the Commission may have already invented an answer to this problem in rule 253 of Regulation A, 17 C.F.R. § 250.253 (1970): (1) the issuer must have had a net income from operations for at least one of the last two fiscal years, or (2) if it does not meet this test then the restricted securities can be sold only if all promotional securities, i.e., stock issued for assets or services (stock could be deemed issued for services if it were issued for a cash consideration of less than, e.g., 75 percent of the sale price of the restricted securities), and securities issued or proposed to be issued to directors, officers, promoters and securities dealers are placed in escrow for one year with a prohibition against public resale to prevent bail-outs by the insiders. Unless the venture capitalists are either able to produce a net income, which is more important to an investor than a revenues test, or are willing to put their money on the line, as promoters of the enterprise, by agreeing to stay in the enterprise for another year, restricted securities of non-reporting companies could not be sold to the public. The important point is that the venture capitalists have the option of not having to comply with an annual gross revenues or net income test. The proposal is somewhat similar to promotional stock restrictions which may be imposed by the California Commissioner of Corporations, see Cal. App. Code § 260.141 (1969), 1 BLUE SKY L. REP. ¶ 8,628 (Sept. 16, 1969), but has the advantage that when the restriction will be imposed and lifted is not left up to the discretion of the administrator, but is made certain by the rule. The California Commissioner's rule also requires the promoters to waive the right to receive dividends and proceeds on liquidation until the restrictions are lifted. Venture capitalists seldom object to these restrictions since new ventures seldom pay dividends and if there is
quirement was the same as for its manpower problem and its concern that qualified issuers had the Commission stamp of approval: It eliminated the annual gross revenue requirement and the qualified issuer concept and established a requirement in rule 144(a)(3) that there be publicly available current information about the issuer which would presumptively be satisfied, i.e., maintenance of a qualified list or strict review of 1934 Act filings is not imposed on the Commission, if the issuer either filed reports under the Exchange Act or published or furnished to its security holders certain financial and other information. Although there are certain mechanical difficulties with paragraph (a)(3) of rule 144, on the whole this paragraph seems to be a definite step forward toward full and fair disclosure and, with certain modifications to make its application more certain, and to give a greater degree of protection from shell corporation distributions, it is suggested that it be incorporated into the 160 Series.

There is another provision of rule 144 which is a definite step forward. Paragraph (a)(4)(B) of the proposed rule would allow the broker executing the transaction (1) to make inquiries regarding the security to be sold and (2) to appear in the "sheets". This is prevented under rule 154. Rule 144 goes slightly further in this regard than the 160 Series rule 162(a)(3) which would permit the broker to appear in the "sheets" only if he had published bid and offer quotations on at a liquidation they are resigned to their failure. The five-year holding period would remain in effect.

See note 120 and accompanying text infra.

A shell corporation would have little difficulty in preparing current information about itself since its operations are limited; the fraud in the shell game lies in the projections of future profits and the method of trading and "touting" which inflates the market unnecessarily. Although the cure for this ill lies in the antifraud and broker-dealer provisions, adoption of a test such as that previously discussed would help in this area while at the same time not imposing a difficult annual gross revenues test and an excessively long holding period on venture capitalists.

Although a less desirable solution, since arguably it may dissuade issuers from filing required reports and would probably require congressional action to amend the 1934 Act, it would seem that the manpower problem could be solved by raising money through the collection of nominal fees in connection with Exchange Act filings by reporting companies. Since such reporting will provide the basis for sales of restricted securities, and unrestricted securities held by controlling persons, it does not seem the chilling effect of a nominal fee would reduce filings.

There does not seem to be a substantive difference between the qualified issuer concept and rule 144(a)(3) at least insofar as the latter attempts to remove the Commission stamp of approval. Both rules permit leakage sales by reporting companies. The fact that rule 144 merely establishes a presumption does not seem to remove whatever Commission stamp of approval is attached to a reporting company. It is submitted that the Commission's concern in this regard is unwarranted, and that the only change rule 144 has made to eliminate this concern is to abandon the term qualified issuer. If this is the small price to pay for eliminating this concern, then by all means the term should be abandoned in favor of the language of rule 144(a)(3), modified as suggested herein.
least seven of the ten consecutive business days before his receipt of the offeror's order and were a bona fide market-maker. When there is a thin market for securities it is often the case that there is only one market-maker. This market-maker may be vital to the maintenance and stability of the thin market. Rule 154 would require that market-maker, who may be the broker which can obtain best execution, to stop making the market. In addition, the market may be so thin that quotes appear in the "sheets" only once every few days. Rule 162(a)(3) would require the market-maker to get out of the market in this situation, if he were the executing broker, because he would not have published quotations on seven of the last ten business days. Rule 144 would allow the market-maker to remain in the thin market and execute transactions. However, as set forth below, rule 144 contains some remarkable missteps and steps backward in the search for certainty.

Missteps and Steps Backward

(1) Both the release containing proposed rule 144 and the rule itself imply that restricted securities may be sold to the public only pursuant to the rule. A person "shall be presumed not to be an underwriter . . . if all of the . . . conditions [of the rule] are met". Then is there a negative inference that a person who sells to the public under circumstances not meeting all of the conditions of the rule is an underwriter? The release states that the changes in circumstances doctrine "relate[s] only to the holding period and not to the other provisions of the rule"; this implies that rule 144 is exclusive, with the minor exception that change in circumstances may shorten the eighteen-month holding period required by the rule. This possible implication takes on more substance when we recall that the 160 Series rules are exclusive; resales of restricted securities to the public can only be made pursuant to the rules. Since perpetual restraints on alienation are viewed with disfavor, the Wheat Report and the proposed 160 Series lifted the restriction from restricted securities after five years. Proposed

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83 Under some circumstances the market-maker would have to disclose his position in the market to his customer. Chasins v. Smith, Barney & Co., CCH FED. SEC. L. REP. ¶ 92,712 (2d Cir. July 7, 1970), modified, CCH FED. SEC. L. REP. ¶ 92,962 (Mar. 2, 1971). The absolute prohibition of rule 154 was formulated before that case was decided. The SEC is presently considering proposed rules for disclosure by market-makers under various circumstances.

84 Proposed rule 144(a).


86 If this is the case, one wonders how the Commission intends to supply any certainty to the change in circumstances area unless it continues the no-action letter procedure it proposed to discontinue in Release No. 5087.

87 See note 50 and accompanying text supra.
rule 144 contains no such outer limit—it thus becomes considerably more burdensome than the *Wheat Report* and the *160 Series*, unless it is interpreted to be nonexclusive. Let us take the case of the former company executive who is discharged by the company shortly after he acquired shares for investment. Since the executive is no longer in a position to persuade the company to give him current information so that he can make sales after the eighteen-month period provided in rule 144, he is locked-in completely if the rule is considered to be exclusive, notwithstanding the length of his holding period, changed circumstances or the nature of his transaction.

The 1933 Act registration procedure is very expensive and requires considerable expertise and time. In recognition of this fact, neither the Securities Act, nor the Commission has sought to lock-in issuers and holders of restricted securities. The private offering exemption permits sales of shares without registration and, after a suitable holding period, the exemption is satisfied and the shares are fully transferable by noncontrolling persons without registration. Casual sales by controlling persons are permitted by rules 133(d) and 154. Any rule, such as rule 144, which purports to require registration for all future sales except for leakage sales permitted by the rule is destined to have a severe adverse impact on venture capital investment because it forces the venture capitalist to either (a) acquire air-tight[89] enforceable[90] registration rights, which the issuer or the venture capitalist may find too burdensome to afford, or (b) buy a security which (except for leakage sales) can be sold only in private placements or other exempt transactions, thus assuming an even greater risk than is being taken by investing in the venture at all. The effect of such a rule will not be to compel more registrations, but to reduce the number of venture investments and subsequent resales and thus reduce the number of registrations. Furthermore, any rule which purports to lock-up restricted

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88 *But see* note 121 *infra.*

89 Various provisions can be inserted in the securities purchased or the purchase agreement which trigger drastic events in the event of failure to register, thus compelling the issuer to register. For example, the venture capitalist may purchase an equity position backed up by debt securities which give the lender the right to accelerate the debt if the issuer fails to register the equity security. Possibly a voting switch provision may be inserted in the articles to the effect that in the event there is a failure to register the shares the holder of the restricted securities will have the right to control the corporation and thereby replace management and have their shares registered. A provision that there may be an "up-stream" conversion of equity into debt in the event of failure to register might be considered, or possibly a provision which requires the issuer to buy back the equity securities, assuming it has the requisite surplus.

90 *See In re* Energy Conversion Services, Inc., CCH Fed. Sec. L. Rep. ¶ 91,549 (Sup. Ct. N.Y. County May 26, 1965), where the court refused to grant judgment against the officers and directors as individuals requiring them to sign the registration statement.
securities indefinitely, unless sold pursuant to the rule, may conflict with the basic underwriter concept in section 2(11) of the Act.\footnote{See note 51 and accompanying text supra.} Accordingly, if the rule is to be adopted, a note should be added to make it clear that it is not exclusive and merely sets forth certain limited cases in which a person is not an underwriter and is not engaged in a distribution, and has no effect on and does not limit all other cases where a person, by virtue of length of holding period, changed circumstances, the nature of his transaction or otherwise, may not be an underwriter and may not be engaged in a distribution.\footnote{Rule 181 proposed by the Wheat Report, which provides that the private offering exemption is deemed to be applicable to the issuance of securities in the acquisition of a going business to not more than twenty-five holders of interests in such business, contains a supplementary note which states the rule is not intended to be exclusive and that, depending upon the circumstances of the individual case, a transaction in which securities are sold to more than twenty-five persons may also come within the private offering exemption. The Wheat Report app. VI-I.} Two other implications of the rule are that (a) under no circumstances could there be a holding period of less than eighteen months combined with changed circumstances which would permit public sale of restricted securities prior to eighteen months and (b) the minimum holding period is thirty months, eighteen months plus a period of twelve months for permitted leakage sales under the rule. Thus, the suggested note should make it clear that the rule does not set a minimum holding period for transactions not covered by it.

(2) The most surprising aspect of rule 144 is contained in paragraph (a)(2)(B). Sales by all directors, officers and affiliates of the issuer and their associates are taken into account for purposes of limiting the amount of securities which may be sold under the rule. This constitutes a vast and unwarranted extension of the Commission's view that "person" for purposes of rule 154 includes "a group of closely related persons."\footnote{See note 86 and accompanying text supra.} It also introduces a great deal of uncertainty because it will be impracticable for the seller and his broker to ascertain the sales by all members of this enlarged rule 144 group, who may be individuals over whom the seller has no control and about whom he has no knowledge. Another effect of rule 144(a)(2)(B) may be to compel a race to the marketplace by the specified persons—in other words, it may induce sales rather than limiting them. Even the winners of the race to the marketplace may find themselves in violation of the rule after the fact as a result of subsequent sales by other members of the group.
CERTAINTY IN THE MARKET

during the twelve-month period which exceed the limitations of rule 144(a)(2).

It is recommended that this paragraph be stricken from the proposed rule and the definition of offeror in proposed rule 162(b) be adopted. At the same time, in computing sales for purposes of paragraph (a)(2)(B), sales between members of the group of persons should be excluded from the limitation.

It is believed that this paragraph is evidence of a strong concern by the Commission as to the large amount of securities being sold simultaneously without registration by separate persons who are in a controlling relationship with the issuer. Perhaps an intermediate solution would be to combine sales by all the persons listed for a short period, such as one month (instead of twelve months), thus reducing a simultaneous selling effort by several persons.

(3) In addition, paragraph (a)(2)(B) unleashes another bombshell by implying that sales by officers and directors whose securities are not otherwise restricted (because they are not controlling persons and did not acquire their shares in a private offering) are limited to the percentage permitted in the rule. The rule should expressly negate this implication since there is nothing in the Securities Act which provides a basis for such an implication.

94 The Wheat Report noted it had been "strongly suggested" that the rule 154-type quantity limitation, which would be carried over into rule 162, should be expressed in terms of 1 percent of the outstanding float, i.e., the floating supply of stock in the market, and not 1 percent of the total number of outstanding shares. The float would be determined by subtracting from the total outstanding shares all securities owned by all officers and directors. "The Study considered this suggestion carefully and determined not to recommend it. The processes of calculation would be complex, and could possibly result in inaccurate data." The Wheat Report 195. One cannot help but think that paragraph (a)(2)(B) of rule 144 is an attempt to accomplish something akin to that which the Wheat Report rejected. This is not to say that the recommendation made to the study does not have validity; it is the author's view that it has considerable merit since it more accurately gears the quantity limitations to the amount of stock which might be expected to be involved in ordinary brokerage transactions on the market. It does not seem unreasonable to make the calculation on a continuous basis from Form 4's and Form 3's filed by officers, directors and 10 percent shareholders under section 16(a) of the 1934 Act, 15 U.S.C. § 78p(a) (1964). This, combined with a recent case implying a private right of action for failure to file such forms, might even induce more prompt and accurate reporting under section 16(a). This would seem to be a much more acceptable alternative than paragraph (a)(2)(B), which looks to actual sales by directors, officers and affiliates whether or not reported to the SEC, making it difficult for a holder of restricted securities who is not an affiliated person or an executive of the company to obtain the information necessary to make the computation and which also seems to imply that a director or officer who is not an affiliate of the issuer is subject to the rule. With respect to companies whose officers, directors and 10 percent shareholders are not required to file reports under the Exchange Act, leakage sales under the rule would not be permitted until the five-year holding period had been satisfied.

95 This can be done by excluding private sales from the limitation. See note 97 and accompanying text infra.
(4) The wording in clause (a) of the rule begs the question by providing that the rule is applicable to a person who has acquired securities "in a transaction not involving a public offering."96

(5) The 160 Series release specifically noted that proposed rule 162 could be relied upon in successive six-month periods. Since there is some question whether rules 133 and 154 may be relied upon during successive periods, either rule 144 or any release adopting it should state that sales limited as described in paragraph (a)(2)(B) may be made in successive twelve-month periods.

(6) Like rule 154, proposed rule 144 does not exclude prior non-public offerings for purposes of the 1 percent limitation in paragraph (a)(2) on the amount of sales in any twelve-month period. This is contrary to proposed rule 162(a)(4) which would permit non-public offerings without affecting the limitation on public sales. No reason appears for this change in position. It seems justifiable to permit the offeror to make sales which are admittedly in compliance with the 1933 Act (non-public offerings) without penalizing his public distribution in accordance with the rule. Thus, a father could sell securities in a private placement to his son without reducing the amount of his permitted public sales under rule 144. Since private sales do not involve a public selling effort, there is no preconditioning of the market for the public sale permitted by the rule.97 The penalty in the rule for prior private sales does not seem designed to accomplish any statutory purpose other than to reduce use of the rule.

(7) Proposed rule 144 does nothing to give certainty to the group concept of person. It had been one of the purposes of the Wheat Report to carefully define the person concept to limit it to members of a carefully defined family group.98 Paragraph (a)(2) gives some idea that it is intended that the person and his associates are the same person; if this is the new outer limit on the person concept, the rule should say so. The importance of doing so is made more evident by rule 144(a)(1)(C), which might well be construed to extend the person's holding period if members of his family (or other persons included in the person concept) made acquisitions of securities. Certainty for the seller and his broker, both of whom must make an inquiry to satisfy the rule, requires a return to a precise definition of offeror as in the Wheat Report.

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96 See note 68 and accompanying text supra.
97 The study sees no compelling reason for this reduction [reducing the quantity which may be sold under rule 154 by sales within the last six months], insofar as prior private placements are concerned, and the test in rule 162 has been modified accordingly. Prior public offerings may stand on a somewhat different footing. Solicitation of buyers is likely to have been widespread during such offerings . . . .

THE WHEAT REPORT 194.
98 See note 63 and accompanying text supra.
(8) The fungibility concept has been preserved in paragraph (a)(2)(A) of the rule. In addition, the rule further exacerbates the fungibility problem caused by acquiring successive blocks of stock because although proposed rule 162(c)(1) provides that the offeror shall not, during the twelve-month holding period, "have purchased or agreed to purchase" any other restricted securities of the same issuer, rule 144(a)(1)(C) provides that the offeror may not, during the holding period, have "acquired or agreed to acquire" any other restricted securities. This change in wording may produce unfavorable results because "purchase" is usually associated with a volitional contract to purchase securities. For example, an offeror holding securities for the period required by rule 144 may find his holding period must be extended if during the holding period a relative makes a gift of, or dies leaving restricted securities to the offeror. Numerous other nonvolitional acquisitions may lead to the same problem: the forced conversion of securities upon a call for redemption; securities acquired upon a recapitalization (even though the offeror voted against it); the grant of preemptive rights; the fortuitous grant of a stock option to an employee who had nothing to do with the grant; a contingent stock acquisition. Rule 144(a)(1)(D) solves the conversion and recapitalization problems but leaves the other situations untouched. Particularly with respect to an employee granted an option by his company, it would seem that the desirable effect of granting options to executive employees should outweigh the impact of the proposed rule, which is to prevent that employee from selling any shares at all under the rule until eighteen months after he has been granted the option. Indeed, the employee can be subjected to substantial hardship in raising capital to exercise his stock option and the company may find it difficult to develop an effective stock option plan when employees learn that by the grant of an option they will be locked-in as to their other restricted securities, no matter how long their previous holding period.

At a minimum it is proposed, therefore, that an exception to this limited fungibility provision be made with respect to options and securities acquired upon exercise of such options, under a plan which

99 See note 55 and accompanying text supra.
101 Proposed rule 162 specifically took care of the gift and death acquisition problems, the contingent stock acquisition problem and other situations by providing tacking benefits. Rule 144(a)(1)(D) limits the tacking benefits to recapitalizations and conversions.
meets the requirements of section 422, section 423 or section 424 of the Internal Revenue Code.\textsuperscript{102} A somewhat comparable provision appeared in rule 162(c) proposed by the \textit{Wheat Report};\textsuperscript{103} this wording did not appear in the Commission's proposed rule 162. At a maximum, the Commission should deal in the rule with the entire problem of non-volitional acquisitions which extend the holding period; a return to the "purchase" terminology of the \textit{Wheat Report} would be a step in the right direction.

(9) Proposed rule 144 would exempt only the transaction by the person actually making the offer and sale. However, as a result of the sale by this person there could be a loss of the private offering exemption for other persons. Proposed rule 180 was designed to prevent loss of the exemption from occurring as a result of any public resale transactions which are exempted by the proposed rule. It is not apparent why a comparable rule was not proposed in conjunction with rule 144.

(10) Present rules 133(d) and 154 now permit sales of the same quantity referred to in paragraph (a)(2)(A) during the six-month period rather than the twelve-month period proposed by rule 144. No reason appears in the release why the Commission decided to cut in half the permissible amount of shares which could be sold by controlling persons under present rule 154 and by holders of restricted securities and controlling persons under the \textit{Wheat Report} rules and the 160 Series. Perhaps the Commission felt that controlling persons have too frequently used rule 154 so that speculative issues have been sold to the public in large quantities without 1933 Act disclosure. Some persons consulted by the Study felt the leakage limits were "far too generous and permit major dispositions of securities."\textsuperscript{104} After analysis of the limitations and an empirical study, the Wheat group was not persuaded that the limitations should be reduced,\textsuperscript{105} but left the door open to decrease the quantity limitations after a period of experience with the proposed rules.\textsuperscript{106} With no experience under the rules (since they have not yet been adopted), the Commission, without comment, has proposed reduced quantity limitations in rule 144.\textsuperscript{107} With the advent of

\textsuperscript{103} \textit{The Wheat Report} 201-02.
\textsuperscript{104} Id. 191.
\textsuperscript{105} Id. 193.
\textsuperscript{106} Id. 245.
\textsuperscript{107} It is possible to speculate that the Commission was trying to solve another problem: rule 154 states only that sales in the "six preceding months" should be taken into account. If a controlling person sells the maximum number of shares on July 1st, and two days later sells shares in a registered public offering, this, in the view of the Commission, subverts the purpose of rule 154 which is to permit casual sales to locked-in controlling persons. The solution to this problem is to look backward and forward from each individ-
NASDQ\textsuperscript{108}, the Commission may now employ the trading volume test as a quantity limitation applicable to casual sales of over-the-counter securities and in this way assure that sales of some of the more speculative issues traded in the over-the-counter market are limited to modest amounts of securities consistent with the trading volume.\textsuperscript{109}

(11) The required inquiry of the seller and his selling broker has been expanded by rule 144 to the point where the uncertainty is unacceptable to the seller and his broker. Proposed rule 164(d) requires that the broker make a reasonable inquiry of his customer. Rule 144(a)(4)(B)(iii) requires a reasonable inquiry but appears (and the release appears to confirm)\textsuperscript{110} to require inquiry beyond the customer. The footnote to rule 144 provides that reasonable inquiry should include inquiry as to the seller's and his associates' transactions and current and non-public information about the issuer. The only source of such information other than the seller and his associates is the issuer, its officers, directors and executives, controlling persons, the issuer's investment bankers and transfer agent. Since these persons and firms are under no obligation to provide the broker with the information and since they may be under a duty not to disclose non-public information and the broker may be under a duty not to use it,\textsuperscript{111} the broker may find it extremely difficult to satisfy the duty of inquiry imposed by
rule 144. The seller and the broker may not have the background in accounting to determine whether the financial statements are “prepared in accordance with generally accepted accounting principles,” nor the close relationship to the issuer to determine if all “material information... as to the issuer’s business and management” has been published. Should the Commission decide not to limit the broker’s duty of inquiry to his customer, at least it should clarify rule 144(a)(4)(A)(iii) and item 9 to indicate that the offering may only be made if the seller represents he has no knowledge of any non-public material information about the issuer, in order to (1) avoid any inference that the seller may comply with the rule by disclosing nonpublic information to the broker and (2) relieve the broker from having to approach the issuer and others to obtain non-public information.

Rule 144(b) delivers the crowning blow to broker participation in a rule 144 transaction. Rule 144 withholds the section 4(4) exemption from the broker if it turns out the transaction is not made “pursuant to the provisions of this rule.” Accordingly, even if the broker made a reasonable inquiry, if it turned out his principal sold more than the rule allows, or that the current public information was inaccurate, etc. the broker would be denied his exemption. Neither rule 154 nor proposed rule 164 are so harsh; both of those rules grant the broker his exemption if he has made his inquiry and is not aware or has no grounds for believing the transactions are not being made pursuant to the provisions of the rule. Rule 144(b) must be revised to return to rule 164.

(12) The Commission states in the release accompanying rule 144 that it proposes to eliminate the no-action letter procedure. Were the Commission at the same time to improve its 1934 Act reporting review so that it could see its way clear to adopt a rule comparable to that proposed by the Wheat Report, the elimination of the no-action letter procedure would be justified because all public sales of restricted securities would be covered by the exclusive Wheat Report proposal. In any event, even if rule 144 were adopted, it should significantly reduce the number of requests for no-action letters by virtue of the greater degree of certainty it provides (assuming the rule is modified as suggested here). The Wheat Report noted that to the extent certainty can be provided, no-action requests would become unnecessary.112 Rule 144 does not provide the certainty which justifies elimination of the no-action letter procedure.

(13) Rule 144 does not deal effectively with the major areas of

112 The Wheat Report 175.
uncertainty, the holding period after which the holder of restricted securities may sell his shares without restriction, and the change in circumstances doctrine, except in the case of death. The 160 Series would eliminate the change in circumstances doctrine and establish a fixed holding period, venture capitalists and other investment purchasers would know in advance the required period of holding after which they are free to sell without restriction. The risk that a change in circumstances may result in loss of the investment is outweighed by the certainty provided by a fixed holding period. In effect, rule 144 is very much like a proposal made to the Wheat group, but which was rejected by it.114

(14) Rule 144 does not contain a six-month waiting period between the effective date of registration of the issuer under the Exchange Act on Form 10 and the date it becomes a qualified issuer. Since a Form 10 is not disseminated to the public as is a 1933 Act registration statement (which contains basically the same information as a Form 10, and requires reporting under the 1934 Act by virtue of a required undertaking),115 it does not seem appropriate to ignore the recommendation of the Wheat Report that there be a six-month waiting period when the registration is on Form 10.116 This seems inconsistent with the opening lines of rule 144(a)(3): “[t]here is publicly available reasonably current and informative information about . . . the issuer.” The fact that a Form 10 appears in the Commission’s public files and is not disseminated to the public when combined with the fact that it becomes automatically effective in sixty days, often before any response has been received from the staff or comments made in response thereto, seems to compel the conclusion that there should be some waiting period during which the Form 10 can be seen by the public, the staff may comment and its comments may be responded to.

(15) The holding period in rule 144(a)(1)(A) applies to all securities covered by the rule, not just restricted securities. Since the rule covers all securities acquired by affiliates,117 the holding period applies to securities acquired by controlling persons in the open market. No
holding period with respect to unrestricted securities was required by rule 154 or the Wheat Report rules.118 The only purpose of a holding period is to prevent the use of private placements by the issuer as conduits for the sale of securities to the public. Rule 144(a)(1)(A) treats restricted and unrestricted securities as fungible for purposes of imposition of a holding period, notwithstanding the statement of the Commission that the fungibility theory has been abandoned.

(16) Rule 144 is merely a “presumption”.119 Whether the presumption established by the rule is rebuttable or conclusive is not stated. Assuming it is rebuttable, the effect of the presumption is merely to cast the burden of proof on the person who wishes to rebut the presumption (the Commission or a private plaintiff). If a private plaintiff can demonstrate that the issuer's current public information was inaccurate or was not timely filed or that there was a subsequent public offering which, when integrated with the sale permitted by the rule, constituted the seller an underwriter, he may be able to rebut the presumption and destroy the exemption provided by the rule to the unwilling seller. This is not the solution to the search for certainty and, as a practical matter, casts the burden on the seller and his broker. The “be presumed to” language should be eliminated wherever it appears in rule 144.

(17) Rule 144(a)(3) does not preserve the objective concept of qualified issuer contained in the Wheat Report and the 160 Series. The reporting issuer must actually file the required reports to qualify under rule 144. A noncontrolling person who holds restricted securities and his broker120 will have a difficult time determining the inside information necessary to determine whether a Form 8-K must be filed, or to determine whether a report filed met all the requirements of the Form. As to non-reporting companies, the noncontrolling person may be uncertain that the current public information is correct. Yet, the rule has the practical effect of either placing the burden on the seller and his broker with respect to these matters or requiring them to act at their peril in the hope that the issuer has filed or published the

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119 Proposed rule 144(a) & (a)(3).
120 See note 110 and accompanying text supra. Liability of issuers for filing defective reports or failing to file required reports might possibly extend to the holder of a restricted security who is prevented thereby from selling under proposed rule 144. A venture capital investor would be well advised to insert a provision in the purchase agreement requiring the issuer to register under the Securities Exchange Act of 1934 upon request, to file all required reports thereunder and to indemnify the investor and his broker against liabilities arising from sales made while reports filed were defective. See 25 Bus. Law. 1008, 1036 (1970).
required current public information. Accordingly, rule 144(a)(3) should be revised to eliminate the requirement that the issuer "does file" reports and require only that the issuer be required to file reports under section 13 or 15(d) of the Exchange Act. As to non-reporting issuers, the nebulous requirement that the issuer publish "material information . . . in regard to the issuer's business and management" should be deleted and specific information should be required. It is recommended that the material information required by items 7, 8, 9 and 10 of Schedule I to Form 1-A set forth in Regulation A be required to be published as of a date within a certain number of months prior to the offering under the rule. This would eliminate doubt as to what information is material and would key the information to certain items of Regulation A which is appropriate for small issues by non-reporting issuers. The proposal also eliminates the apparent requirement of rule 144 that the information be kept up to date down to the date of the offering.

CONCLUSION

The search for certainty has been difficult. It seems evident that rule 144 will require either a major revision in order to provide the necessary certainty or will have to be abandoned in favor of the more certain concepts embodied in the Wheat Report proposals and the 160 Series. Certain concepts embodied in rule 144 are worth salvaging and should be incorporated into the 160 Series. Rule 144 has served the purpose of producing a reexamination of the impact of the 160 Series upon small issuers, venture capitalists and upon the Commission itself. Out of the conflict and debate which ensued, much has been learned which should now be reflected in a few substantive additions to and changes of the 160 Series.

As the economy finds its way back to the level of infusion of venture capital into small business characteristic of the period during which the Disclosure Policy Study was being conducted, the need for certainty in the area of disposition of restricted securities will become even more urgent.121 It has been over two years since the Wheat Report
was published and it now seems appropriate that the Commission take affirmative action to adopt such changed 160 Series of rules.

of Form S-16 is limited to securities of issuers whose securities are listed on a national securities exchange, see Form S-16, general instruction A(a)(1). If Form S-16 were the sole method by which restricted securities could be sold in the absence of full registration on Form S-1, it would conflict with the concern of the Commission for the ability of small companies to raise capital, see note 75 and accompanying text supra. Accordingly, rules with respect to the disposition of restricted securities in the absence of registration are still necessary.