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Rule 144: SEC Regulation of Dispositions of Securities by Controlling Persons and Private Places

Paul L. Sloan, III

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NOTES

Rule 144: SEC Regulation of Dispositions of Securities by Controlling Persons and Private Placees

I. INTRODUCTION

In recent years, dissatisfaction with the law that governs the disposition of securities by controlling persons[1] and private placees[2] under the Securities Act of 1933 has been voiced in numerous commentaries. Although criticism has been directed at varying facets of the problem, the displeasure of critics has resulted from two fundamental objections: first, the unnecessary ambiguity that heretofore has enveloped public resale of privately placed securities and, to a lesser degree, resale of securities by controlling persons; and secondly, the failure of the present law adequately to effect the disclosure policy of the Securities Act of 1933[3] and of the Securities Exchange Act of 1934.[4] Spurred by these legitimate concerns, the Securities and Exchange Commission has recently rescinded rules 154[5] and 155[6] and in their place has adopted a number of remedial rules and amendments.

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1. Controlling persons are generally defined in terms of ability to direct the management and policies of an issuer. *See* notes 52-55 *infra* and accompanying text. The consequences of control are far reaching. Controlling persons, for example, are liable jointly and severally with and to the same extent as the controlled issuer under the Securities Act of 1933 unless they had no knowledge of or a reasonable ground to know of the facts that constitute the issuer's violation. Securities Act of 1933 § 15, 15 U.S.C. § 77o (1970); Securities Exchange Act of 1934 § 20, 15 U.S.C. § 78t(a) (1970). *See generally* Sommer, *Problems of Controlling Persons and Their Brokers*, in FIRST ANN. SECURITIES REGULATIONS INST. 25 (1969); Sommer, *Who's in "Control"—SEC*, 21 BUS. LAW. 559 (1966). The problems of controlling persons with which this Note is concerned are those relating to statutory and regulatory inhibitions of the Securities Act of 1933 on the resale of securities, whether acquired on the public market or in a private transaction.

2. As used in this Note, the term private placees refers to those persons who have acquired securities in an unregistered nonpublic offering from an issuer or a controlling person. *See* notes 30-51 *infra* and accompanying text.

3. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970).

4. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh-1 (1970). Foremost of the critics has been Francis M. Wheat, past Chairman of the Securities and Exchange Commission. In 1967, Commissioner Wheat was appointed to head a study group which was to examine the operation of the disclosure provisions of the securities acts. The heart of the Study Group's report, submitted in 1969, treated the problem of secondary distributions. In an effort to rid the area of its many ambiguities and to bring it more in line with the disclosure policies of both the 1933 and 1934 Acts, the group study recommended a number of remedial rules, the "160 Series." Many of the features of Rule 144, as finally adopted, reflect those of the 160 Series. DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS—THE WHEAT REPORT (CCH ed. 1969). [hereinafter cited as WHEAT REPORT].

5. 17 C.F.R. § 230.154 (1970), *rescinded*, Securities Act Release No. 5223 (Jan. 11, 1972).

6. 17 C.F.R. § 230.155 (1970), *rescinded*, Securities Act Release No. 5223 (Jan. 11, 1972).

Pivotal to these changes is Rule 144,[7] which brings the resale of securities by private placees and controlling persons under a single regulatory scheme. In addition to lending a degree of predictability to a former morass of confusion, the rule breaks substantially with precedent by utilizing the improved reporting machinery of the 1934 Act to ensure the availability of current public information during secondary sales by controlling persons and private placees. Achieving this coordination has required a dramatic shift in the construction of the 1933 Act by the Commission and its staff. It is the purpose of the present inquiry to evaluate in detail the new interpretive approach of Rule 144, and to examine the mechanics of the rule, its component parts, and related rules and amendments.

It is helpful at the outset to have some appreciation of the immense importance of private placements and sales by controlling persons to the well-being of the corporate community. The prohibitive expense of a registered public offering has made the private placement an indispensable instrument for corporations that wish to raise moderate amounts of capital.[8] Private placements have become the primary method by which emerging corporations seek to raise "seed money," and, in at least one of the last five years, they have accounted for over 35 percent of the outstanding debt securities sold in the United States.[9] It therefore is apparent that any regulatory change in the disposition of privately placed securities could have a profound impact on the vitality of the corporate community. Similarly, the vast number of controlling persons affected by Rule 144 can be readily appreciated by remembering that the existence of every corporation presupposes the concomitant existence of at least one controlling person or group of persons.

7. 37 Fed. Reg. 591 (1972), *to be codified at* 17 C.F.R. § 230.144 [hereinafter cited as Rule 144].

8. H. BLOOMENTHAL, SECURITIES LAW 121 (1966). It has been estimated that the cost of going public for a small business attempting to raise $1,000,000 through a registered public stock offering could amount to 20% of the face value of the security. Note, *Proposed SEC Rules for Private Offerings: The Impact on Venture Capital Financing,* 5 U. MICH. J.L. REF. 122, 124 & n. 14 (1971); *Private Placement: The "New" Money Game,* 93 DUN'S REVIEW 81 (Feb. 1969).

9. The greatest volume of privately placed securities are debt instruments placed with insurance companies. In the 1960-63 period, for example, half of all new corporate bonds were privately placed. At least one authority has remarked that "[p]rivate placement is still almost exclusively a market for debt instruments, although there has been a small absolute, and a large relative, increase in the amount of common and preferred stocks placed privately." FRIEND, LONGSTREET, MENDELSON, MILLER, & HESS, INVESTMENT BANKING AND THE NEW ISSUES MARKET 337 (1967); *accord,* Address by George S. Chase, Salomon Brothers Seminar on Private Placements, Nov. 17, 1971. *See generally* 1 L. LOSS, SECURITIES REGULATION 689-96 (2d ed. 1961).

II. The Statutory Scheme For Regulation of the Distribution of Securities

A. Policy Considerations

The Securities Act of 1933 is designed to assure that the public investor is given the benefit of "full and fair disclosure" regarding the character of securities and the nature of business by all issuers who seek financing through public offerings.[10] It is, however, initial public offerings, or distributions,[11] with which the Act is primarily concerned—"the flow of securities from the issuer through underwriters to the public rather than with the subsequent buying and selling of these securities by the public."[12] Thus, most resales by nonissuers are characterized as "trading" rather than as "distributions" and can therefore be freely executed without the necessity of registration.

Beyond this statement of the general rule, the simplicity of the trading-distribution distinction vanishes. There are, for example, two kinds of subsequent resales by nonissuers that, if permitted without registration, would subvert the disclosure policy of the Act. First, secondary distributions by controlling persons may "possess all the dangers attendant upon a new offering of securities."[13] Because of the possible volume of such offerings, their market impact, the active solicitation of buyers during such offerings, and the payment of high sales commissions, large volume resales by controlling persons clearly bear little resemblance to normal trading and should be subject to the same disclosure requirements as imposed on initial distributions[14]—particularly since the controlling status of the seller minimizes his burden of persuading the issuer to undergo registration.

Secondly, resales made by persons who have purchased securities

10. Act of May 27, 1933, ch. 38, Preamble, 48 Stat. 74. The Preamble also states as one of its purposes the prevention of fraud in connection with the sale of securities. The key fraud provisions of the Act which implement this antifraud purpose are §§ 12(2) and 17. Securities Act of 1933, 15 U.S.C. §§ 77l(2), 77q (1970). Compliance with Rule 144 exempts the seller only from the registration requirements of the Act. Both §§ 12(2) and 17 apply to the seller whether or not he is exempted from the registration requirements of § 5.

11. 1 L. Loss, *supra* note 9, at 551.

12. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 36 (1959) (an excellent account by one of the 3 persons who penned the first completed draft of the Securities Act during a weekend in April of 1933); 1 L. Loss, *supra* note 9, at 130.

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

14. "Wherever such a redistribution reaches significant proportions, the distributor would be in a position of controlling the issuer and thus able to furnish the information demanded by the bill. This being so, the distributor is treated as equivalent to the original issuer and, if he seeks to dispose of the issue through a public offering, he becomes subject to the Act." *Id.* at 13-14.

from the issuer or a controlling person of the issuer in a private placement may frustrate the policy objectives of the Act. The inherent danger in this kind of nonissuer resale arises from the suitability of the private placement mechanism as a conduit for the distribution of unregistered securities by the issuer or controlling person to the public. If private placees were given unfettered freedom to resell securities purchased in private placement, then issuers and controlling persons could avoid registration merely by altering their methods of distribution. Thus, while the original private placement may not constitute a public offering, the Act's disclosure policy requires carefully drawn restrictions on the resale of privately placed securities.

Before examining the means by which the 1933 Act's disclosure policy has been implemented, consideration should be given to certain policies of the SEC and its staff in administering the Act. The SEC has been given tremendous latitude to flesh out the skeletal provisions of the Act and it can be fairly said that the ultimate realization of the Act's disclosure policy rests upon the wisdom with which the Commission exercises its interpretive and enforcement powers.[15] This statement is particularly true of the Commission's power to regulate secondary sales by controlling persons and private placees through its definition of such key terms as "brokers' transaction," "distribution" and "controlling person."[16] The subtleties and ambiguities of the Act and the economic consequences of a misinterpretation make it imperative that the Commission provide the securities bar with an empirically workable system of regulations that ensures a high degree of certainty and predictability. The Commission, however, is also charged with the full and effective enforcement of the Act; this responsibility often calls for the propagation of flexible, or even vague, guidelines, in order to retain maximum latitude to deal with those who would manipulate the mechanics of the rules to subvert the spirit of the Act.[17] The dialectic of these two policies—certainty and predictability for the smooth operation of the Act and flexibility for the effective enforcement of the Act—has played a key role in the evolution of Rule 144.[18]

15. WHEAT REPORT *supra* note 4, at 153-56.

16. Among the expressed powers given the Commission by § 19(a), is the authority to define "accounting, technical and *trade terms* used in this title." 15 U.S.C. § 77s(a) (1970) (emphasis added).

17. *Cf.* SEC v. Micro-Moisture Controls, Inc., 148 F. Supp. 558 (S.D.N.Y. 1957), *aff'd sub. nom.*, SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959); Great Sweet Grass Oils Ltd., 37 S.E.C. 683 (1957).

18. *See* Schneider & Kant, *Uncertainty Under the Securities Act*, 26 BUS. LAW. 1623, 1635-36 (1971).

B. Regulatory Structure

To permit the free and open trading of securities while preventing a flow of initial and secondary distributions to the public without full and fair disclosure, the 1933 Act and the rules promulgated thereunder provide an elaborate web of proscriptions and exemptions. The basic provision of the Act, section 5,[19] makes it unlawful for any person to sell any securities through the use of any means or instruments of transportation or communication in interstate commerce or of the mails unless a registration statement relating to such securities is in effect. Expansive in scope, this proscription embraces not only issuers, controlling persons, and private placees, but all persons, whether trading in securities or engaged in a distribution of securities.

Those upon whom the Act does not intend to place the burden of registration, therefore, look beyond section 5 for relief. Their sanctuary is provided by section 3,[20] which exempts specified securities from the requirements of section 5, and by section 4,[21] which exempts specified transactions. These two provisions exclude the vast majority of sales from registration. Thus, the legislative intention to limit the disclosure mechanism of section 5 to distributions is effected through a hybrid method of "selective nonexclusion."[22] A significant result of this method is that all persons seeking to sell securities, in whatever quantity or manner, must find their own exemptions.[23] That *A's* securities have previously been the subject of exemption or registration is irrelevant to the question whether *A* can now sell the same securities without registration.[24] *A* must find his own exemption or comply with the requirements of section 5. Likewise, *A's* broker, who acts as an agent in executing the sale, must find his own exemption. The Commission, moreover, has long taken the position that the burden of demonstrating the presence of an exemption rests on the person who is relying upon its availability.[25]

Section 4 and its related definitions provide the instrument by

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19. 15 U.S.C. § 77e (1970).

20. 15 U.S.C. § 77c (1970).

21. 15 U.S.C. § 77d (1970).

22. Comment, *Sales of Control Stock and the Brokers' Transaction Exemption—Before and After the Wheat Report*, 49 TEXAS L. REV. 475, 476 (1971).

23. Another significant consequence of this statutory scheme is that, with a few exceptions, the exemptions of §§ 3 & 4 relieve the sellers only from the registration requirements of § 5. They do not exempt the seller from the antifraud provisions of §§ 12(2) & 17. 15 U.S.C. §§ 77l(2), 77q (1970).

24. The only exceptions to this situation occur in relation to the limited varieties of securities that are excluded from the coverage of the 1933 Act by § 3(2)-(11), 15 U.S.C. § 77c(2)-(11) (1970). 1 L. Loss, *supra* note 9, at 708-09.

25. Securities Act Release No. 4669 (Feb. 17, 1964).

which Congress and the Commission have attempted to draw the rather delicate lines between public and nonpublic offerings and between ordinary trading and distributions. This section exempts the following:

4(1) — Transactions "by any person other than an issuer, underwriter, or dealer . . . ."
4(2) — transactions "by an issuer not involving any public offering,"
4(3) — transactions by a dealer except those in certain close relationship to a distribution, and
4(4) — unsolicited brokers' transactions executed upon a customer's order.

The noncontrolling public investor, by virtue of section 4, is free to sell his securities through his broker without registration. The investor is neither an "issuer," an "underwriter," nor a "dealer," and is therefore exempt under section 4(1); his broker, moreover, although unable to avail himself of section 4(1) since he is by definition a "dealer" under section 2(13),[26] is exempt under section 4(3)[27] or section 4(4).[28]

Obviously, the intricacies of section 4 can become far more puzzling, but elaboration is here necessary only with regard to private placees and controlling persons. The section 4 exemption most often relied upon by both these groups when reselling their securities to the public is section 4(1). To come within section 4(1), however, each group must demonstrate that it includes neither issuers, underwriters, nor deal-

26. "The term 'dealer' means any person who engages either for all or part of his time, directly or indirectly, as agent, *broker*, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person." 15 U.S.C. § 77b(12) (1970) (emphasis added).

27. Section 4(3) exempts transactions by dealers. Excluded from the exemption, however, are transactions taking place within 40 days after the securities have been registered and bona fide offered (90 days if it is the first time the issuer has made a registered offering). Also excluded are transactions in any unsold allotment being sold in a registration and not sold within the 40 or 90 days, and transactions during which a stop order under § 8 is in effect. Since it was not the intention of Congress to prevent trading by public investors, even during the time that the securities are in registration or subject to a stop order, § 4(4) was added to permit brokers to sell for customers through normal trading activities. Thus a broker who is unable to sell stock as a dealer for his own account during registration under § 4(3) may sell securities of the same issue for the account of a customer in a broker's transaction under § 4(4). That the broker is a dealer to whom § 4(1) is not available does not prevent his being a broker for purposes of § 4(4). Similarly, the unavailability of § 4(3) when the securities are in registration or subject to a stop order does not prevent the broker from selling the securities of a customer under § 4(4). Comment, *supra* note 22, at 489-91.

28. Note that even though the broker is also a "dealer" and therefore unable to avail himself of § 4(1), his capacity as a dealer does not prevent his capacity as a broker from qualifying under the § 4(4) exemption of brokers' transactions.

ers. Thus emerges the key significance of section 2(11)'s definition of an "underwriter."[29] Under section 2(11), a person is a statutory underwriter if he:

(1) purchases from an issuer "with a view to . . . the distribution" of securities, or
(2) "offers or sells for an issuer" in connection with such distribution, or
(3) directly or indirectly "participates" in such distribution.

Moreover, for the purpose of determining section 2(11) underwriter status only, an issuer is defined to include "in addition to an issuer," any person "directly or indirectly controlling" the issuer. Thus, one who purchases securities from an issuer *or from a controlling person,* "with a view to" distribution will become a statutory underwriter and therefore will not be able to rely on section 4(1) for an exemption. Further significance of the section 2(11) definition should become increasingly apparent in the following discussion of resales by private placees and controlling persons.

C. Pre-Rule 144 Resales by Privatc Placees

The policy of the 1933 Act does not compel the registration of "private offerings" as opposed to "public offerings."[30] As long as an offering is limited to a small group of experienced and sophisticated investors who "have a relationship with the issuer that gives them access to the same information that would be in the form of a registration statement,"[31] imposition of the requirements of section 5 is unnecessary. The Act, therefore, provides the issuer with the section 4(2) exemption for any transaction "not involving any public offering." Although 4(2) is strictly an *issuer's* exemption, the Act also provides, albeit through a tortured interpretive route, a similar private offering exemption to controlling persons.[32]

The inherent danger of private placements as a method of distribution to the public necessitates a vigilant containment of the private

29. 15 U.S.C. § 77b (11) (1970).

30. Landis, *supra* note 12, at 37. In describing the intended scope of the Act, Landis remarked: "'Public offerings' as distinguished from 'private offerings' proved to be the answer. The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government. That bureaucracy, untrained in these matters as it was, could hardly equal these investors for sophistication, provided only it was their own money that they were spending." *Id.*

31. SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953).

32. *See* text accompanying notes 62-64 *infra.*

offering exemption. To serve this end, the Act and the SEC restrict the two fundamental elements of a private placement—the issuer's original placement of securities with the group of private placees, and the subsequent resale of those securities by the private placees. Were either ignored, an unregistered distribution of securities to the public could be accomplished. The first element of the private placement exemption requires that no offeree be a person whose lack of sophistication and unfamiliarity with the issuer place him in need of the Act's protection.[33] The public-private offering dichotomy therefore, is resolved by looking to the needs of the offerees and not merely to their numbers.[34]

Although the issuer's original offering may have been made to a sufficiently limited number of sophisticated investors, thus satisfying the first element, the preservation of the issuer's private offering exemption will depend on whether the securities offered have come to rest in the hands of the initially informed group or whether the private placees serve as conduits for a wider distribution to persons in need of the Act's protection. The securities "come to rest" if the private placees purchase with an "investment intent" or without a view to distribution. An immediate effort by the private placee to resell his securities before they have come to rest would cause his offerees to be included among those in the original placement and thereby retroactively jeopardize the issuer's section 4(2) exemption, and the private placee would himself become a section 2(11) underwriter for whom the section 4(1) exemption would not be available.

Prior to the adoption of Rule 144, the SEC's determination that the private placee was an underwriter when he resold his securities usually meant that he came within the first of section 2(11)'s three disjunctive conditions: the purchase of securities from the issuer "with a view to . . . [their] distribution." As applied to the private placee, "distribution" is the antithesis of "holding for investment." To avoid statutory underwriter status the reselling private placee therefore had to

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

34. The number of offerees is relevant "only to the question whether they have the requisite association with and knowledge of the issuer which make the exemption available." Securities Act Release No. 4552 (Nov. 6, 1962). Among other factors are the size of the offering, facilities used in making the sale, and the number of units being offered. *Id. See generally* Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Gilligan, Will & Co., 38 S.E.C. 388 (1958), *aff'd*, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959); H. BLOOMENTHAL, *supra* note 8, at 121-34; 1 L. LOSS, *supra* note 9, at 653-65. As in the area of resales by private placees, the requirements relating to the original placement in a § 4(2) private offering have been fraught with confusion and vague guidelines. There have been indications that the SEC will attempt to clarify this area by more precise guidelines. BNA SECURITIES REG. & LAW REP. No. 140, A-1 (Feb. 23, 1972).

demonstrate that, at the time of his purchase from the issuer, he took with a view to holding for investment.[35] If after making his resale, the private placee were deemed to have purchased from the issuer with an improper "view," exemptions evaporated: the purchaser lost his 4(1) exemption because he had purchased from an issuer with a view to distribution; retroactively, the issuer's exemption was jeopardized, since the securities never came to rest in the purchaser's hands;[36] and any broker who helped in either sale lost his 4(3) and 4(4) exemptions since his participation in the distribution made him an underwriter.[37]

The crucial determination of "underwriter" status turned almost entirely on the subjective state of mind of the purchaser. The requisite state of mind was suggested by the purchaser's subsequent conduct—what he actually did following his purchase was evidence of what he intended to do at the time of purchase. Absent a change in circumstances that might explain a departure from original intent,[38] a sale promptly after an investment purchase was evidence that the holder purchased with a view to distribution.[39] Conversely, the passage of a

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35. Securities Act Release No. 5121 (Dec. 30, 1970).

36. *Id.* Since the issuer has an obvious interest in restricting resale by its private placees, it has been customary for it to insist on a letter of investment intent from each of its placees. Additional precautions include the issuance of stop-transfer instructions to prevent the transfer of the securities and a legend stamped on the face of the certificate stating that the securities have not been registered under the Securities Act of 1933 and may be offered and sold only if registered or if an exemption from registration is available. Although the Commission has made it clear that the self-serving "letter of intent" will not conclusively establish the proper investment intent, failure to utilize these precautions is evidence of the absence of proper intent. Securities Act Release No. 5121 (Dec. 30, 1970). This policy has been continued with the introduction of Rule 144. The Commission has stated that failure "to inform the purchaser fully as to the circumstances under which he is required to take and hold the securities" constitutes a violation of § 17(a) of the 1933 Act and § 10(b) of the 1934 Act. Securities Act Release No. 5226 (Jan. 10, 1972).

37. Note that once a broker becomes an underwriter he cannot at the same time claim broker or dealer status for purposes of § 4(3) or § 4(4). To permit otherwise would subvert the policy of the Act. Ira Haupt & Co., 23 S.E.C. 589, 604 (1946). In contrast, if statutory underwriter status is avoided, the broker is both a broker and dealer and can use either § 4(3)'s dealer's exemption or § 4(4)'s broker's exemption when appropriate. *See* note 27 *supra.*

38. The change of circumstances doctrine permitted the private placee to sell his securities before the normally accepted holding period had expired without having the sale discredit his original investment intent. The theory was predicated on the occurrence of intervening factors unforeseen or not easily foreseeable by the private placee and of such proportions that they compelled the departure from an original investment intent. Morrow, *The Investment Letter Dilemma and Proposed Rule 144: A Retreat to Confusion,* 11 SANTA CLARA LAW. 37 (1971). The doctrine was strictly applied and the change generally had to be both material and extraordinary in nature. Moreover, although the doctrine worked to excuse the necessity of holding, the shorter the securities were held the more dramatic the change of circumstances had to be. Merrifield, *Private Placement Exemption,* 4 REV. SEC. REG. 943 (1971).

39. Note, *The Investment-Intent Dilemma In Secondary Transactions,* 39 N.Y.U.L. REV. 1043 (1964).

sufficient period of time or the occurrence of a sufficiently compelling change of circumstances permitted the purchaser of investment securities to sell all his holdings without having his resale considered as evidence of an original intention to distribute.[40]

The period of retention necessary to free privately placed, or "lettered," stock was never certain. Against a backdrop of official insistence that the duration over which securities were held was only evidentiary and not in itself conclusive,[41] the proper length of the "holding period" became an elastic concept of intolerable caprice. Without any available administrative interpretation, the securities bar snatched at any official utterance that suggested the existence of a precise talisman. At one point, the period was thought to be one year;[42] later, a casual remark by Commissioner Cohen that hinted the acceptability of a two-year holding period was promptly adopted as a standard by the bar;[43] subsequent experience, however, indicated that the SEC staff would not issue a favorable "no-action" letter unless privately placed securities had been held by the investor for three years or more.[44] To this confusion were added further uncertainties relating to the "change in circumstances" doctrine and the severity of the change necessary to permit resales without registration by the private placee prior to the expiration of the

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40. "The normal scenario for the sale of restricted stock in the public markets adheres to the following script. The seller stockholder obtains an opinion of counsel justifying the desired sale and submits this opinion to company counsel. If the latter approves the opinion, he instructs the transfer agent to remove the legends and 'stop transfer' orders from the securities in question. This entire process takes no more than a few days to effectuate." Lowenfels, *SEC "No-Action" Letters: Some Problems and Suggested Approaches*, 71 COLUM. L. REV. 1256, 1264 n.46 (1971). The problem arises when company counsel will not accept the proffered "opinion letter." Prior to the adoption of Rule 144, the private placee was then forced into the arduous process of seeking a "no-action" letter from the SEC. The release announcing the adoption of Rule 144 states that the staff will no longer issue *any* "no-action" letters relating to resale of privately placed securities. Securities Act Release No. 5223 (Jan. 11, 1972). It is hard to believe that Rule 144 has so clarified the area of resales by private placees whose opinion of counsel is rejected by the company. The release does state that the staff will issue "interpretive letters to assist persons in complying with the new rule." It remains to be seen whether interpretive letters will adequately alleviate the potential hardship.

41. "[T]he 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 be considered." Securities Act Release No. 4552 (Nov. 6, 1962); *Accord,* Securities Act Release No. 3825 (Aug. 12, 1957). *See also* Lowenfels, *supra* note 40, at 1258-59.

42. United States v. Sherwood, 175 F. Supp. 480 (S.D.N.Y. 1959); Brooklyn Manhattan Transit Corp., 1 S.E.C. 147, 162-63 (1935) (holding period under § 3(a)(11) intrastate exemption); Securities Act Release No. 1862 (Dec. 14, 1938).

43. 1 L. Loss, *supra* note 9, at 671-72.

44. *See* Lowenfels, *supra* note 40, at 1258-59.

holding period.[45]

Holders of investment securities were further plagued by the "fungibility doctrine." Under this concept, all securities of the same class were assumed to be equal or interchangeable regardless of their certificate numbers or the time at which they were purchased. Although never the subject of an official ruling or interpretative release,[46] the fungibility doctrine caused securities purchased on the market to bear the same taint as securities of the same class acquired in a private offering. Thus, any person who sold publicly acquired securities immediately after acquiring the same class of securities in a private placement would be deemed an underwriter even though the actual certificates sold had been purchased in a public transaction.

The uncertainties and ambiguities created by the imprecise holding period, the change of circumstances rule, and the fungibility doctrine were lamented by the bar and the Commission.[47] The bar found it virtually impossible to provide clients with satisfactory advice. Paradoxically, this particular grievance was felt most acutely by the expert securities lawyers who were most familiar with the intricate pitfalls of the private offering. Moreover, few among knowledgeable lawyers rendering a good faith judgment on a given problem would draw the same conclusion. "Opinion shopping" was widely engaged in by purchasers seeking an opinion on the availability of an exemption. Given that the more informed attorneys would have the greater propensity to express reservation, opinion shopping tended to place a premium on ignorance of the law.[48] For the private placee, the confusion unnecessarily impaired the liquidity of his investment. For the Commission, the vagaries precipitated a growing volume of requests for "no-action" letters. Not only did the administrative burden of responding place an unnecessary strain on the staff, but inconsistent responses to the requests jeopardized the staff's credibility.[49]

The dissatisfaction with the subjective intent-oriented approach to resales by private placees went far beyond the confusion it created. As a realistic construction of the statutory language, the approach was a contrivance:

> [T]he entire mystique of investment intent is generally unresponsive to reality and

45. *See* Kennedy, *The Case of the Scarlet Letter or The Easy Way Out on "Private Offerings,"* 23 BUS. LAW. 23 (1967).

46. WHEAT REPORT, *supra* note 4, at 174; Samet, *The Concept of Fungibility in Securities Laws*, 27 BUS. LAW. 383 (1972).

47. WHEAT REPORT, *supra* note 4, at 164-74.

48. For an explanation of why "opinion letters" are necessary see notes 36 & 40 *supra*.

49. Schneider & Kant, *supra* note 18, at 1630.

> unrelated to the way people aetually think and act. Virtually no one buys a marketable security as he would an heirloom, without contemplating the possibility of sale at some future date.[50]

When immediately before acquiring his securities a private placee asked his attorney the inevitable question: "How long must I hold before I am permitted to resell?" the attorney was in an awkward position. Logically, the lawyer must have insisted that the question be retracted, because if it were not, the private placee would have manifested a preconceived intention to sell which no holding period could cure. Additionally, the attorney had to confess that even later, when the question could properly be asked, no definite answer would be possible.[51]

The SEC's construction of the private placement also failed to effect the policies of the 1933 Act. Through the private placement exemption a large volume of securities came on to the market without attendant disclosure. Moreover, the existence of a holding period or a change in the investor's circumstances bore little relationship to the public's need for disclosure. From the disclosure viewpoint, it made little difference whether a large block of securities were dumped on the market by a private placee three months, six months, or three years after the initial purchase from the issuer or controlling person.

D. Pre-Rule 144 Dispositions By Controlling Persons

1. *Definition of Control.*—Attempting to identify "control" is one of the more thankless exercises required by the 1933 Securities Act. Although it attaches immense consequences to that status,[52] the Act provides no definition. Two tests, of marginal utility, are available. Rule 405 provides the first:

> [T]he term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.[53]

The second test asks: what individual or group has the power to cause the officers and directors to sign a registration statement? This test is appropriate because only an issuer can execute and file a registration statement.[54] Within these broad boundaries lies a vast wasteland, with isolated clues to be gleaned from case law.

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50. *Id.*
51. Schneider & Kant, *supra* note 18.
52. *See* note 1 *supra.*
53. SEC Rule 405, 17 C.F.R. § 230.405(f) (1971).
54. Pennaluna & Co. v. SEC, 410 F.2d 861, 865 (9th Cir. 1969), *cert. denied,* 396 U.S. 1007 (1970); Frank, *Sales of Securities by "Controlling Persons" Under the Federal Securities Act,* 14 HASTINGS L.J. 137, 139 (1962).

Since the Commission presumes the existence of control as Rule 144's point of departure, an extended treatment of control is here not intended. It is sufficient that the plight of the security holder of uncertain status be noted. In determining whether a security holder is a controlling person, it must be noted that control can be formal or informal, direct or indirect, can exist by virtue of a contract, office, security holdings, relationship to a controlling person, or inclusion in a controlling group (none of whose several members would be controlling if removed from the group).[55] The power to control is sufficient; it need not be exercised. In addition, the security holder's ascendancy to control may be fortuitous as well as intentional. To indulge in literary license, some holders, it seems, are born to control, some achieve control, and some have control thrust upon them.

2. *Consequences of Control.*—The characterization of a security holder as a controlling person serves to define the peripheral reach of the Act's requirement that when practicable, full, accurate, and current information be made available to the public during any sizable distribution. Consequently, the Act permits the unregistered sale of a sizable block of publicly acquired securities held by a noncontrolling person, but it may require registration if the same or a smaller block is being sold by a controlling person. This distinction, which is most apparent when control exists by virtue of an executive position, seems well founded, since the leverage necessary to compel the issuer to register the securities should be imputed only to a controlling person.[56]

The 1933 Securities Act regulates dispositions of securities by controlling persons through its definition of statutory underwriter in section 2(11). For the sole purpose of identifying an underwriter, section 2(11) defines "issuer" to include any controlling person. Thus, a broker who sells securities for a controlling person may be selling securities for an "issuer" in connection with a distribution and therefore would be deemed an underwriter as to the securities if the sale were held to constitute a distribution. Since broker and underwriter statuses are deemed to be mutually exclusive, the newly characterized underwriter can no longer rely upon the brokers' transaction exemption under section 4(4).[57] Deprived of his exemption, the broker, who executes the sale in violation of section 5, is faced with liability under the Act and with loss of his broker's license.[58] Weighed against a sales commission,

55. *See generally* Flanagin, *The Federal Securities Act and the Locked-In Stockholder,* 63 MICH. L. REV. 1139, 1142-50 (1965); Sommer, *supra* note 1, at 562-83.

56. *See* note 14 *supra.*

57. *See* note 37 *supra.*

58. *See* Securities Exchange Act of 1934 § 15A, 15 U.S.C. § 78o-3 (1)(2) (1970).

these sanctions ensure the broker's cautious reticence when requested to make a sale for a controlling person.

The place of thc controlling person in this scheme is less clear. Although the loss of the broker's exemption is an effective bar to unregistered distributions by controlling persons, it is a contested question whether section 4(1)'s exemption of transactions not involving an issuer, underwriter, or dealer is available to the controlling person. The controlling person is not an issuer under section 4(1) because his status as an issuer is conferred only for the purposes of section 2(11). If he bought his controlling securities on the public market, he cannot be said to be selling them for the issuer within the second part of the section 2(11) underwriter definition. This statutory ambiguity has led at least one authority to suggest that the controlling person's liability exists only by virtue of his aiding and abetting the broker.[59] The vast majority of commentators, however, subscribe to the theory that, although the controlling person is not himself an underwriter under section 2(11), the "involvement" of an underwriter (i.e. his broker) is sufficient to deprive the controlling person of his 4(1) exemption.[60] Yet a third theory, of tortured logic, holds that the controlling person is himself an underwriter because of "participation" with his broker in the distribution of the securities. At varying points in the development of this theory, the controlling person is a controlling person, an issuer, and an underwriter, and all within the language of section 2(11).[61] The common element of all these theories is their reliance on the presence of a statutory underwriter who helps in the sale of the controlling person's securities. It is therefore apparent that a controlling person's broker, whose assistance is a practical necessity, is the key party. If the broker can escape underwriter status, he will be exempted under section 4(4) and the controlling person will be exempt under section 4(1).

3. *Dispositions of Securities by Controlling Persons.*—Prior to the adoption of Rule 144, controlling persons could dispose of securities in two kinds of transactions: the private placement and the brokers' transaction.

59. The aiding and abetting statute relied upon is Act of June 25, 1948, 18 U.S.C. § 2(b) (1970). 11 H. SOWARDS, BUSINESS ORGANIZATIONS—THE FEDERAL SECURITIES ACT § 4.04(3) (1965); Sowards, *Private Placements and Secondary Transactions: The Wheat Report Proposals for Reform,* 1970 DUKE L.J. 515, 524.

60. 1 L. LOSS, *supra* note 9, at 705 n.178; Flanagin, *supra* note 55, at 1142-50. Comment, *supra* note 22, at 485-86 n.65.

61. Comment, *supra* note 22, at 484 n.53. The authors have noted the inappropriateness of this theory since the "participating" language of section 2(11) was intended to apply to middlemen down the chain of distribution and not to the initiating party. *Id.*

(a) *Private placement of publicly acquired securities.*—The section 4(2) nonpublic offering exemption is available to the issucr alone.[62] A private offering exemption, nevertheless, is available to the controlling person who wishes to dispose of publicly acquired securities through a broker. The exemption relied upon by the controlling person is section 4(1). If the sale is limited to a small number of sophisticated investors, it is not treated as a "distribution;" the broker selling the securities will not be an underwriter under section 2(11); and therefore the controlling person will not lose his section 4(1) exemption, since no underwriter is "involved" in his sale of securities. This "private placement" exemption for controlling persons generally has been viewed as coextensive in its requirements with the issuer's section 4(2) nonpublic offering exemption, although each springs from a distinct statutory origin.[63] This reasoning assumes that "distribution" is synonymous with "public offering."[64] If the controlling person has tailored his resale to conform with the requirements imposed upon thc issuer in a private offering, then no distribution is deemed to have occurred; therefore, the resale is exempt under section 4(1).

(b) *Disposition of securities in Rule 154 brokers' transactions.*—Section 4(4) of the 1933 Securities Act and interpretive Rule 154,[65] now superseded by Rule 144,[66] provided guidelines for the broker and controlling person in selling control securities without registration. By defining "brokers' transactions," "distribution," and "solicitation of such orders," the rule sets forth the quantity and manner in which a sale was required to be made for the broker to avoid statutory underwriter status. The restrictions on the method of sale were intended to ensure that the disposition would resemble normal trading activity and not the distribution of securities to the public.[67] The requirements included:

(1) The broker had to perform no more than the "usual and customary broker's function."
(2) He could do no more than execute the controlling person's order to sell and receive no more than the "usual or customary broker's commission."
(3) Neither the broker, "nor to his knowledge his principal," could solicit orders to buy the controlling securities.

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62. *See* note 25 *supra* and accompanying text.
63. Comment, *supra* note 22, at 487.
64. WHEAT REPORT, *supra* note 4, at 161-62.
65. 17 C.F.R. § 230.154 (1971).
66. Securities Act Release No. 5223 (Jan. 11, 1972).
67. *Id.*

In addition, the broker who adhered to these requirements would still not qualify for the section 4(4) exemption if he was aware "of circumstances indicating that his principal was an underwriter . . . or that the transaction was part of a distribution."[68]

The rule's definition of distribution was limited in scope to broker sales of control securities. In contrast to Rule 144, it did not, for example, define the term for private offering purposes. Under Rule 154 a broker selling securities for a controlling person was deemed not to be engaged in a distribution if the number of securities of the same class sold by the controlling person within the preceding six-month period, did not exceed specified percentage limitations. If the security was traded over-the-counter, the limitation was "approximately" one percent of the total outstanding securities. If the securities were traded on an exchange, the limitation was "approximately" one percent of the lesser of either the total outstanding securities or the largest aggregate reported volume of trading on securities exchanges during any one of the past four weeks.[69]

III. Operation of Rule 144[70]

A. Overview

Rule 144 became effective April 15, 1972; its evolution has been

68. SEC Rule 154, 17 C.F.R. 230.154 (1971). Thus, Rule 154 was not available to controlling private placees, if their resale was made before their securities had come to rest in their hands. If, however, the broker did make such a sale, he would be excused from sharing his customer's underwriter status if he could show he was not aware of his customer's distribution. Similarly, if his control customer was making a distribution of publicly acquired securities by using a number of different brokers, each of whom had no reason to be aware of the distribution, the brokers would be able to retain their § 4(4) exemption even though they were in fact participating in the distribution. United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969).

When the controlling person is distributing publicly acquired securities through a number of brokers who are unaware of the distribution, this "good faith exemption" poses an immense conceptual barrier to holding the controlling person in violation of the § 5 registration requirement, since a broker must be an underwriter in order to deprive the controlling person of his § 4(1) exemption. *See* text following notes 57 & 58. For an excellent treatment of this problem and the inconsistencies it creates see Comment, *supra* note 22, at 495-500. The authors suggest that by permitting the "good faith" broker continued exemption under § 4(4) when he is unknowingly participating in a distribution by the controlling person, the Commission has exceeded its rule-making authority. The most persuasive argument on this point is that since § 2(11) contains no support for the distinction once a distribution exists, and since § 12(1) of the Act imposes strict liability on persons selling in violation of § 5 either knowingly or otherwise, the Commission has no power to do indirectly through Rule 154's definition of brokers' transactions that which the Act expressly prevents. *Id.* at 511-12.

69. 17 C.F.R. § 230.154(b) (1970), *rescinded*, Securities Act Release No. 5223 (Jan. 11, 1972).

70. In preparation for this Note, the author attended a 2-day securities law program hosted

the subject of several excellent commentaries and will not be reviewed here.[71] Together with eight related rules and amendments that help facilitate its operation,[72] Rule 144 has marked a major step towards removing much prior confusion and bringing the administration of the Act more in line with its policy objectives.

1. *Purpose of the Rule.*—The purpose of the rule is to provide for "full and fair disclosure of the character of securities sold in trading transactions and to create greater certainty and predictability in the application of the registration provisions of the Act by replacing subjective standards with more objective ones."[73] The rule's operation is designed to inhibit "the creation of public markets in securities of issuers concerning which adequate current information is not available."[74] Through the rule, the Commission has sought to bring about greater coordination and integration of the 1933 and 1934 Acts and to implement a continuous disclosure system.[75]

Rule 144 defines those transactions in which the securities of a private placee (whether or not a controlling person) and the publicly acquired securities of a controlling person may be publicly sold without constituting a distribution and without the private placee or a broker

by Northwestern University School of Law on March 27 and 28, 1972. During the second day, 8 participants addressed the various component features of Rule 144. The 8 were Alan Appelbaum, Neil Flanagin, Warren F. Grienenberger, Alan B. Levenson, Burton R. Rissman, Donald E. Schwartz, A. A. Sommer, and Herbert S. Wander. Much of the following analysis is derived from the lectures delivered by these men and will be noted by reference to their individual addresses.

71. The first formally proposed rules relating to dispositions by controlling persons and private placees were the "160 Series" recommended by the *Wheat Report* and proposed by the Commission in 1969. Securities Act Release No. 4997 (Sept. 15, 1969). Subsequently, the Commission withdrew these proposals and substituted the first proposed Rule 144. Securities Act Release No. 5087 (Sept. 22, 1970). The first proposed Rule 144 met wide opposition from the bar. Among its more objectionable features were a holding period for controlling persons and presumptions under which those who complied with the rule were merely presumed not to be engaged in a distribution. In response, the Commission issued a Revised Proposed Rule 144. Securities Act Release No. 5186 (Sept. 10, 1971). The revised proposal represented a substantial improvement over the earlier proposal, and with further refinement became the presently adopted Rule 144. *See* Chalmers, *Grist from Wheat: The New SEC Ground Rules for Venture Capital,* 25 BUS. LAW. 1001 (1970); Holland, *Public Sale of Control Stock and Private Investment Stock: The SEC's Proposed New Rules,* 25 BUS. LAW. 1027 (1970); Morrow, *supra* note 38; Sowards, *supra* note 59.

72. The 7 related rules, amendments and releases are: Exchange Act Releases Nos. 9442 & 9443 (Jan. 10, 1972) (Amendments to Form 10-K and 10-Q under the Securities Exchange Act of 1934); Exchange Act Release No. 9310 (Sept. 13, 1971) (Rule 15c2-11); Securities Act Release No. 5226 (Jan. 10, 1972) (applicability of antifraud provisions); Securities Act Release No. 5225 (Jan. 10, 1972) (Amendment of Regulation A under § 3(b)); and, Securities Act Release No. 5224 (Jan. 10, 1972).

73. SEC Rule 144, Securities Release No. 5223 at 5 (Jan. 11, 1972).

74. *Id.* at 17.

75. *See* Cohen, *"Truth in Securities" Revisited,* 79 HARV. L. REV. 1340 (1966).

of the controlling person therefore becoming a statutory underwriter under section 2(11).[76] In contrast to rescinded Rule 154, the fulcrum of Rule 144 is not the definition of brokers' transactions under section 4(4), but the definition of *distribution* under section 2(11). Conceptually, this shift in emphasis facilitates the inclusion of sales by private placees and controlling persons within the purview of a single rule.

In one of the rule's more dramatic departures from past law, the Commission has made the existence or nonexistence of a distribution, when securities are sold by either a private placee or a broker for a controlling person, a function of three factors:[77]

(1) whether there exists "adequate current information concerning the issuer . . .;"
(2) whether the seller has owned his securities for a sufficient amount of time to demonstrate that he has assumed the risk of his investment and is therefore not "acting as a conduit for the public sale of unregistered securities" by the issuer; and
(3) whether the sale is made in a manner and quantity that does not disrupt the trading market.

Prior to the adoption of the rule, the private placee had only to satisfy the second factor and the controlling person to satisfy the third.[78] Now, the private placee must not only hold his securities for a sufficient holding period (two years under the rule), but must also ensure that there is adequate current information concerning the issuer and that his sale is made within the quantity limitations of a one percent "leakage" or "dribble" rule and in the manner of a broker's transaction. A broker selling publicly acquired securities for a controlling person must not only continue to conform to quantity and manner restrictions, but must also ensure the availability of adequate current information concerning the issuer. The controlling person is relieved, however, of any holding period requirement for his publicly acquired securities since the public purchase demonstrates that he is not serving as a "conduit for the public sale of unregistered securities" by the issuer.

2. *Definition of Terms.*—The rule begins by defining "affiliate," "person," and "restricted securities." An affiliate is a controlling per-

76. The rule has been adopted pursuant to § 19(a): "The Commission shall have authority . . . to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter, including rules . . . defining accounting, technical, and trade terms used in this subchapter." Securities Act of 1933, 15 U.S.C. § 77s(a) (1970).

77. Preliminary Note to Rule 144, SEC Rule 144, Securities Act Release No. 5223 (Jan. 11, 1972).

78. *See* text accompanying notes 30-69 *supra.*

son. Restricted securities are securities acquired from an issuer or an affililate "in a transaction or chain of transactions not involving any public offering."[79] Thus a private placee (whether or not a controlling person) holds restricted securities. An affiliate who has acquired his control securities on the open market holds nonrestricted securities. His status as a controlling person, not the source of his securities, is the reason his sales are limited.

"Person" is defined to include the person who sells securities under the rule, his spouse, relatives, spouse's relatives living with the person, and any estate, trust, or business of which ten percent is beneficially owned individually or collectively by any of the aforementioned "persons".[80] In addition, the rule requires inclusion of those who "agree to act in concert for the purpose of selling securities" when determining the amount of securities that such person can sell under the rule.[81]

3. *Conditions of the Rule.*—Section (b) of the rule provides that an affiliate or nonaffiliate who sells restricted securities or a broker who sells restricted or nonrestricted securities for an affiliate "shall be deemed not to be engaged in a distribution" if all conditions of the rule are met.[82] Thus the rule is available only to persons, controlling or noncontrolling, who sell securities acquired from the issuer or an affiliate of the issuer in a nonpublic offering and to controlling persons

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79. SEC Rule 144(a)(3), 37 Fed. Reg. 591(1972).

80. SEC Rule 144(a)(2), 37 Fed. Reg. 591(1972). "The term 'person' when used with reference to a person for whose account securities are to be sold in reliance upon this section includes, in addition to such person, all of the following persons: (i) Any relative or spouse of such person, or any relative of such spouse, any one of whom has the same home as such person; (ii) Any trust or estate in which such person or any of the persons specified in subdivision (i) of this subparagraph collectively own 10 percent or more of the total beneficial interest or of which any of such persons serve as trustee, executor or in any similar capacity; and (iii) Any corporation or other organization (other than the issuer) in which such person or any of the persons specified in (i) are the beneficial owners collectively of 10 percent or more of any class of equity securities or 10 percent or more of the equity interest." This section is essentially the same as that contained in the revised proposed Rule 144. It has, however, substituted a precise 10% test for trust and estates in lieu of the far more ambiguous "substantial beneficial interest" test used in the revised proposal. Revised Proposal Rule 144, Securities Act Release No. 5186 (Sept. 10, 1971).

One ambiguity is created, however, by a format change. The revised rule has set out family attribution rules in 2 sections: "(A) The spouse and minor children of such person; (B) Any relative of such person or of his spouse who has the same home as such person." *Id.* The present rule, however, can be read to mean that the spouse and relative of the seller are included only if they have the same home. The SEC staff has apparently adopted this more realistic interpretation. CCH FED. SEC. LAW REP. No. 421 at 5 (Apr. 26, 1972).

81. SEC Rule 144(e)(3)(vi), 37 Fed. Reg. 591 (1972). SEC staff members have indicated that concurrent sales by corporate directors, standing alone, would not constitute concerted action, although an inquiry might be prompted. Wander, *Rule 144 Adopted,* 5 REV. SEC. REG. 958, n.3 (1972).

82. SEC Rule 144(b), 37 Fed. Reg. 591 (1972).

selling nonrestricted securities. The rule is not available, for example, to an issuer or to a dealer who is a member of a selling group in a registered public offering and who would like to sell an unsold portion of the allotment.[83]

The remainder of the rule sets forth the five conditions that must be met. If satisfied, the conditions assure the nonexistence of a distribution. Their headings are: "current public information," "holding period for restricted securities," "limitations on amount of securities sold," "manner of sale," and "notice of proposed sale."

B. Current Public Information

The rule's first condition, that there exist "available adequate current information," is predicated upon the belief that unregistered public sales by controlling persons and private placees should be permitted only if the issuer of the securities sold is making current public disclosures concerning its finances and business.[84] To this end, the rule relies heavily on the improved reporting requirements of the 1934 Act; although the condition may be satisfied by nonreporting companies, the rule evidences a clear preference for use of the machinery of the 1934 Act to satisfy its disclosure requirement.

1. *Reporting Companies.*—With a few exceptions, issuers listed on a national exchange (section 12(a) companies),[85] issuers with 500 or more equity security holders and a total asset value in excess of 1,000,000 dollars (section 12(g) companies),[86] and issuers who have registered securities under the 1933 Act (section 15(d) companies),[87] are required to file reports pursuant to sections 13 and 15(d) of the 1934 Act and are therefore "reporting companies."[88] In addition, any issuer

83. In these cases, the dealer would not have acquired his securities from the issuer *in a transaction not involving any public offering.* Address by Alan B. Levenson, Securities Law Program, Northwestern University School of Law, Mar. 28, 1972 [hereinafter cited as Northwestern].

84. *Cf.* Cohen, *supra* note 75; *ABA Federal Regulation of Securities Conference on Codification,* 22 Bus. Law. 793 (1967).

85. Securities Exchange Act of 1934 § 12(b), 15 U.S.C. § 78l(b) (1970).

86. *Id.* § 12(g), 15 U.S.C. § 78l(g) (1970).

87. *Id.* § 15(d), 15 U.S.C. § 78o(d) (1970). The § 15(d) reporting requirement is automatically suspended after the first year of registration if the number of securities holders of the same class as were sold in the registered offering reaches fewer than 300. *Id.*

88. Section 15(d) companies are required to file periodic reports under § 15(d); § 12(b) and (g) companies are required to file periodic reports under § 13. In addition, § 12(b) and (g) companies are required to conform with federal proxy rules under § 14 of the 1934 Act and their officers, directors and 10% shareholders are subject to § 16 of the 1934 Act, which requires reporting of their transactions in the issuer's securities and prohibits short-swing profits thereon. *Id.* § 15(d), 15 U.S.C. § 78o(d) (1970); *Id.* § 13, 15 U.S.C. § 78m (1970). *Id.* § 14, 15 U.S.C. § 78n (1970); *Id.* § 16, 15 U.S.C. § 78p (1970). Although the § 15(d) companies are "reporting companies"

may voluntarily become a reporting company under section 12(g) of the 1934 Act by filing the reports required under section 13.[89]

Rule 144(c)(1) provides that the information requirement is satisfied if the issuer has been filing current reports under either section 13 or 15(d) of the Exchange Act for at least 90 days prior to the sale and has filed its most recent annual report.[90] The 90-day requirement is double edged. First it ensures the currency of the information, and secondly, it requires that the issuer have been a reporting company for the 90-day period. In effect, the latter aspect imposes a three-month waiting period on sales of the securities of a company that has just begun to report under the Exchange Act.[91]

It is, of course, the seller or broker of the seller, not the issuer, who is concerned most with the satisfaction of the rule's information requirement as well as its other requirements. What assurance does the broker or seller have that a reporting issuer whose securities he is attempting to sell under the rule has complied fully with the 144(c)(1) requirement? In contemplation of this problem, forms 10-K and 10-Q, the annual and quarterly reports required of most reporting companies under sections 13 and 15(d), have been amended to require the issuer's statement of whether all reports required to be filed "within the past 90 days" have been filed.[92] The rule entitles the seller to rely upon the issuer's statement of compliance that appears either in the most recent annual or quarterly report or in a written statement from the issuer, unless the seller "knows or has reason to believe" that the issuer has not complied with the information requirements.[93]

The scope and application of the reliance provision are not altogether clear. The breadth of the "has reason to believe that the issuer has not complied" clause, for example, is uncertain. Clearly, controlling persons in the executive hierarchy of the issuer could not rely upon the issuer's written statement that it has complied when in fact it has not, but precisely what degree of intimacy with corporate affairs is necessary

(§§ 12(b), (g) and 15(d) companies) are essentially the same, consisting of an annual report (Form 10-K, filed within 90 days of fiscal year end), a quarterly report (Form 10-Q, filed within 45 days of the first 3 fiscal quarters), and current reports of significant corporate events (Form 8-K, filed within 10 days of the end of any month in which the event occurred). 17 CFR §§ 240.13a-1 to -13, 240.15d-1 to -13 (1971).

89. Securities Exchange Act § 12(g), 15 U.S.C. § 78l(g) (1970).

90. The Chief Counsel of the SEC Division of Corporation Finance has been cited as saying that an issuer who has been reporting for 90 days but has not been required to file an annual report will be deemed to have satisfied the information requirement. Wander, *supra* note 82, at 958 n.5.

91. Address by Burton R. Rissman, Northwestern, Mar. 27, 1972.

92. Securities Exchange Release No. 9442 (Jan. 10, 1972).

93. SEC Rule 144(c)(1).

to impute to the seller the "reason to believe"? Similarly, it is uncertain whether a broker is entitled to rely on the issuer's statement. The rule refers only to the "person for whose account the securities are to be sold," but at least one authority has taken the position that the broker could also rely on such statements.[94] In addition, there are a number of problems related to the timing of the issuer's statement. How contemporary, for example, must the issuer's "written statement" be? Since the seller is entitled to rely on the issuer's warranty of compliance as it appears in the most recent annual or quarterly report, is it sufficient that a "written statement" has been given at some time between the filing of the most recent report and the time of sale?[95] These problems hopefully will be sorted out during the normal administration of the rule.

2. *Nonreporting Companies.*—Persons who would like to sell the securities of a nonreporting company under Rule 144 are given little assistance. Subsection (c)(2) provides that, with the exception of insurance companies, nonreporting companies must make available the information contained in new Rule 15c2-11(a)(4).[96] The seller, however, is given no hint about what will constitute the public availability of such information. Alan Levenson has stated that it will not be sufficient merely to deliver the information contained in Rule 15c2-11 to the broker and that the determination whether the information is publicly available will be made on a case-by-case basis until there has been enough experience with the requirement to establish some guidelines.[97]

The difficulty of accumulating the information called for in Rule 15c2-11(a)(4) and the absence of any guidelines relating to public availability of the information seriously impair access to Rule 144 by affiliates and restricted security holders of nonreporting companies. Although the holder might be willing to risk noncompliance, it is far less likely that any broker would do so absent clear guidelines.[98] A possible solution

94. Address by Burton R. Rissman, Northwestern, Mar. 27, 1972.

95. *Id.* Another problem is created by the time requirements of Forms 10-K, 10-Q, and 8-K, *supra* note 88. Assume Form 10-K is filed on March 30 for the first fiscal quarter with an issuer's statement of compliance. The seller, in reliance, sells on April 15. There is no way for the seller to know whether Form 8-K (current report filed within 10 days after the month in which a significant corporate event occurred) should have been filed if in fact one was not filed. Address by Burtrn R. Rissman, Northwestern, Mar. 27, 1972.

96. Securities Exchange Release No. 9310 (Sept. 13, 1971). Rule 15c2-11 attempts to prevent creation of public markets in "shell corporations" without adequate disclosures. Information concerning the issuer is required to be made available to the broker and public in certain instances before the securities of the issuer can be submitted to quotation media. Rule 144 uses the majority of the itemized information listed in Rule 15c2-11 and applies it to nonreporting issuers seeking to fulfill its information requirement.

97. Address by Alan B. Levenson, Northwestern, Mar. 27, 1972.

98. Addresses by Alan Appelbaum & Burton R. Rissman, Northwestern, Mar. 27, 1972.

would be for security holders to press for the issuer's voluntary registration under section 12(g) of the Exchange Act and thereby make the more specific guidelines of 144(c)(1) available.[99] Although encouraged by the Commission,[100] the voluntary registration option may be of marginal utility to the seller and issuer. Not only does registration under the 1934 Act impose reporting obligations and potential liabilities on the issuer and seller, but the seller may also find that since the issuer is a small company with limited shareholders, the small market in his securities will make it virtually impossible to comply with the rule's further requirement that the sale be executed in unsolicited brokers' transactions.

C. Holding Period

The second condition of the rule is that the person for whose account restricted securities are sold must have been the beneficial owner of the securities for at least two years.[101] The two-year holding period is intended to ensure that the holder of restricted securities has assumed the unconditional economic risk of his investment and therefore has not acquired the securities as a conduit for the issuer's sale of unregistered securities. Although the length of the holding period may be questioned,[102] its presence has clarified one of the major sources of prior confusion by expressly answering the question "how long must I hold?" In addition, the Commission has eliminated the change of circumstances doctrine for sales occurring under Rule 144, recognizing that "the circumstances of the seller are unrelated to the need of investors for the protections afforded by the registration and other provisions of the Act."[103]

1. *Restricted Securities Acquired by Purchase.*—Consistent with its belief that the private placee must assume the economic risk of his investment, the rule provides that, if the securities have been purchased, the two-year period will begin to run only when "the full purchase price or other consideration shall have been paid or given . . . ."[104] Subsec-

99. Aside from the disparity of bargaining power between issuer and noncontrolling private placees, there are a number of hurdles which impede effective registration covenants. In the absence of the issuer's full cooperation, for example, it is unclear whether the investor could obtain specific performance. If he could not, it is uncertain how his damages would be measured. Address by Burton R. Rissman, Northwestern Mar. 27, 1972.

100. Securities Act Release No. 5223 at 14-15 (Jan. 11, 1972).

101. SEC Rule 144(d)(1).

102. *See* Wander, *supra* note 82, at 958.

103. Securities Act Release No. 5223 at 3 (Jan. 11, 1972).

104. SEC Rule 144(d)(1).

tion (d)(2) imposes a limitation on purchases of restricted securities with promissory notes, installment contracts or other obligations of future payment. These methods of payment are deemed not to be full payment of the purchase price and therefore the running of the holding period does not begin unless each of the following conditions are met. First, the note, contract, or obligation must provide for "full recourse against the purchaser of the securities." Secondly, the note must be "secured by collateral, other than the securities purchased, having a fair market value at least equal to the purchase price of the securities purchased." Finally, the note must have been discharged by payment in full prior to the resale of the securities.[105] Although the second condition leaves the time for determining the adequacy of the collateral open, the staff has taken the position that if a decline in its fair market value will cause adequate collateral to become inadequate, the holding period will be tolled until the adequacy of the collatcral has been restored.[106]

2. *Application of the Fungibility Doctrine.*—For sales occurring under the rule, the Commission has eliminated the doctrine of fungibility.[107] Acquisition by a restricted security holder during the holding period of additional securities of the same issuer, whether restricted or nonrestricted, will therefore not start the holding period running anew. The only vestige of the doctrine is a provision that calls for the tolling of the holding period during a time when an owner of restrieted securities has a short position or holds any put or option to dispose of securities of the same class or securities convertible into the same class.[108] If the rationale of the tolling provision is to deny private placees the opportunity of using short sales or puts to avoid the requirement of assuming the economic risk of their investment, then the Commission is guilty of overkill. To illustrate, assume *A* is the beneficial owner of 1,000 shares of restricted *X* stock for which he has paid the full purchase price. Although a subsequent put for 50 shares of the same class of *X* minimizes the economic risk of one twentieth of *A's* investment, the hybrid fungibility element of the rule operates to toll the holding period of *A's* entire 1,000 shares. Even if *A* purchased an additional 50 shares in the open market to cover his put and thereby preserved the entire economic risk of his restricted stock holding, the provision nevertheless would toll the two-year period for the entire 1,000 shares. In addition,

105. SEC Rule 144(d)(2).

106. Address by Neil Flanagin, Northwestern, Mar. 27, 1972. It also should be noted that as the debt decreases, the staff has conceded that the collateral may decrease accordingly. Wander, *supra* note 82, at 959 n.8.

107. Securities Release No. 5223 (Jan. 11, 1972). *See* note 169 *infra.*

108. SEC Rule 144(d)(3).

A must be cautioned that any put, short or option to sell stock of the same class made by another person within the "attribution circle"[109] of "person" as defined in section 144(a)(2) will cause the holding period of his 1,000 shares to be tolled.

3. *Guidelines for Tacking.*—By providing specific "tacking" guidelines, Rule 144 has clarified another source of prior confusion in the area of private placements. The rule addresses two kinds of situations in which tacking causes the holding period of restricted securities to relate back to the time of some prior acquisition. The first situation relates to tacking the holding period of restricted securities to that of previously acquired securities in the hands of a single holder, and the second relates to tacking the holding periods of restricted securities between two or more holders.

Subsections (d)(4)(A)-(C) provide that for purposes of determining their holding periods, securities acquired in stock dividends, stock splits or reverse splits, recapitalizations, conversions, or as contingent payments in business combinations are deemed to have been acquired at the time the underlying securities were acquired. To gain the benefit of this tacking provision, certain qualifications must be met. Under the rule, in a conversion the holding period of the surrendered security can be tacked to that of the underlying security; the provision requires, however, that the underlying securities be received "*solely*" in exchange for the surrendered securities. It is not clear whether this limitation on the permissible consideration prohibits the payment of cash for fractional shares or the satisfaction of unpaid interest on the underlying security.[110] Similarly, restrictions surround the use of tacking when contingent shares are issued pursuant to a corporate fusion agreement. The tacking of contingent issuances is limited to contingent security payments for an equity interest in or for assets of a business sold to the issuer or affiliate of the issuer.[111] Moreover, the conditions of the contingency must not require payment to the issuer by the recipient of the contingent security of any further consideration, with the exception of agrcements for continued employment or noncompetition. If these conditions are met, then the holding period of issued contingent securities will relate back to the time at which the equity interest or assets were sold to the issuer or its affiliate. The contingent tacking provision is most helpful in acquisitions of businesses whose uncertain value requires the total

109. "Attribution circle" is here used to refer to persons included in the rule's definition of "person."

110. *Cf.* Address by Neil Flanagin, Northwestern, Mar. 27, 1972.

111. SEC Rule 144(d)(4)(C).

consideration to be conditioned on the future earnings of the acquired business or on the future market value of the issuer's securities. Although they are not expressly mentioned, the provision seems broad enough to include statutory mergers and consolidations as well as asset and securities acquisitions. The provision also seems broad enough to permit the use of a different class or form of security in the contingent issuance.[112] Although the requirements surrounding contingent issuances appear soundly drawn, the rule's treatment of stock dividends, stock splits, reverse splits, and recapitalizations seems somewhat anomalous, since in these cases the securities generally are acquired in public transactions rather than the private transactions necessary to make them "restricted" securities subject to the holding period.[113]

Subsections (d)(4)(D)-(G) address tacking of holding periods among two or more security holders.[114] Underpinning these provisions is the proposition that a subsequent holder of restricted securities "steps into the shoes" of the person from whom the restricted securities were acquired. The subsections provide that in certain instances restricted securities sold by a pledgee, acquired by gift, or through a trust are deemed to have been acquired at the time they were acquired by the pledgor, donor, or settlor.[115] For a pledgee to tack the period of retention of the pledgor to his own holding period, the pledgee's sale of the securities must follow a default in the obligation secured by the pledge.[116] In addition, the securities must have been bona fide pledged, with recourse, and by a person other than the issuer.[117] Tacking by donees of restricted securities is limited only by the requirement that the donor not be the issuer.[118] A trust is permitted to tack the settlor's holding period and beneficiaries of the trust are permitted double tacking of the settlor and trust's holding periods. This double tacking opportunity also is available to the purchaser of restricted securities from a

112. Presumably the same would be true for dividend payments and recapitalizations. It is by definition the case in conversions.

113. Wander, *supra* note 82, at 959 n.10.

114. For tacking by estates and their beneficiaries see notes 148-53 *infra* and accompanying text.

115. Note, however, the way in which the sales are aggregated. *See* notes 148-53 *infra* and accompanying text.

116. SEC Rule 144(d)(4)(D).

117. *Id.* When restricted securities are pledged without recourse, the pledgee's holding period runs from the time of the pledge. *Id.* It is uncertain when the holding period would begin to run if the pledge were not bona fide or the pledgor were the issuer. Presumably the holding period would not begin to run until the pledgee could demonstrate that the equivalent of full consideration had been given.

118. The need for this condition may be questioned since the issuer would have no recognizable holding period to tack.

pledgee who has tacked the holding period of the pledgor.[119]

Although not expressly mentioned, subsection (d)(4), because of the "attribution circle" of 144(a)(2)'s definition of "person . . . for whose account securities are sold" could create effective tacking—including multiple tacking—for persons who acquire restricted securities from within their own attribution circle, since such transactions would be among individuals defined to be the same person.[120] This attributive tacking arguably would occur whether a pledge, gift, trust, or estate were involved. Moreover, a pledgee who is also a relative living in the household of the pledgor would be able to "tack" the holding period of the pledgor even if, for example, the securities were pledged without recourse. If tacking within the attribution circle is permitted, as logically it must be, there is an open question whether the relationship necessary for attribution must exist during the entire two-year holding period, or merely at the time of the acquisition, or at the time of sale.

With the exception of attributive tacking, no tacking is permitted in situations for which there is no express provision. Accordingly, a private placee of restricted securities is not able to tack the holding period of others to that of his own and a holder of restricted securities who has purchased securities that have been held for a year must hold them for an additional two years.[121]

The language of the tacking provisions relating to stock dividends, splits, recapitalizations and conversions makes the application of the rule somewhat uncertain when any of these transactions occur after the underlying securities are in the hands of someone other than the original holder. If, for example, a stock dividend is paid on restricted securities which have been transferred by the original holder to a trust, when will securities received in the dividend be deemed to have been acquired by the trust? Since the trust is able to tack the settlor's holding period for the underlying security with its own,[122] a visceral response might be to relate the securities acquired in the dividend back to the time at which the settlor acquired the underlying security. This solution, however, is not clearly supported by the language of the rule, which provides that "securities acquired from the issuer as a dividend . . . shall be deemed

119. Presumably, the occasion for double tacking by a purchaser from a pledgee would only arise when default occurs within 2 years of the pledgor's original purchase. This would require that the pledgee's sale have been made by an avenue other than Rule 144. The same double tacking privilege is given heneficiaries of estates. *See* note 148 *infra* and accompanying text.

120. Address by Neil Flanagin, Northwestern, Mar. 27, 1972.

121. There is no need, however, for the holder to aggregate his sales with those of the private placee from whom he received his securities. *See* SEC Rule 144(e)(3)(A)-(G); Wander, *supra* note 82, at 959.

122. SEC Rule 144(d)(4)(F).

to have been *acquired* at the same time as the securities on which the dividend . . . was paid."[123] This language also covers stock splits and recapitalizations and similar language is used for conversion.[124] The difficulty is that there have been two acquisitions, one by the settlor, and one by the trust. To permit the trust to tack vis-à-vis the securities acquired in the dividend, the first acquisition must be controlling and the sentence read to mean "acquired at the same time as the securities on which the dividend . . . was paid for *by the original holder.*" While this construction may seem emminently fair in the present instance, it could be unreasonable in another. Assume, for example, that the restricted security, upon which the subsequent dividend was paid, was transferred to a pledgee in a non-bona fide pledge or to a private placee in a private placement. When the same construction is given, the pledgee or private placee, for whom tacking of underlying securities is denied, could tack for purposes of determining the holding period of the securities received in the dividend. It is submitted that the most reasonable answer would be to permit the original acquisition to control, but only if subsequent acquisitions are by persons or entities who are permitted by the rule to tack the holding periods of the underlying securities. This would permit, for example, a trust receiving restricted securities to tack not only the settlor's holding period for the underlying securities to its own, but also to relate any dividends paid on the securities back to the time of the settlor's purchase. This would prevent, however, a non-bona fide pledgee from tacking his dividend holding period, since the rule would not permit his tacking of the underlying securities.

D. Securities Sales Limitation

To sell securities under Rule 144 controlling persons and private placees holding restricted securities must comply with the percentage limitation set out in subsection (e)(1) of the rule. The new inclusion of private placees within the percentage restrictions may be justified by much the same reasoning that accompanied the departure of the change of circumstances doctrine. It has been argued that the length of time during which a private placee refrains from selling his entire holdings has little relation to the impact on the market that the sale might have. A disruptive effect is just as likely to occur if a large block of stock is sold ten years after the placement as it would be if the stock were sold within two years after the placement. Rule 144 therefore places empha-

123. SEC Rule 144(d)(4)(A) (emphasis added).
124. *Id.* at (d)(4)(A),(B).

sis on the distributional character of the subsequent sale, not the intention or "view," of the private placee at the time of his purchase. The statutory support for imposing an amount limitation on resale by private placees is found in section 2(11). That section makes a person an underwriter not only if he takes from the issuer with the present intention of making a distribution but also if he takes with an investment intent and then later participates in a distribution. The Commission therefore seems to be shifting its emphasis from the "taking with a view to" language to the "participating in a distribution" phrase of section 2(11).[125]

1. *Percentage Limitation on Sales.*—Affiliates of the issuer and restricted security holders under Rule 144(e) are limited in the amount of securities that they can dispose of during a specified period of time to a one percent leakage or dribble provision. More precisely, if the securities are admitted to trading on a national securities exchange, sales in each six-month period are limited to the lesser of:

> (1) one percent of the shares or other units of the class outstanding as shown by the most recent report or statement published by the issuer, or
> (2) [one percent of] the average weekly reported volume of trading in such securities on all exchanges during the four calendar weeks preceding [the sale] . . . .[126]

If the securities are not traded on a national exchange, the limitation is one percent of the shares or other units of the class outstanding as shown by the most recent report or statement published by the issuer without consideration of the average weekly volume.[127]

Although these leakage provisions are much the same as those applied to controlling persons by prior Rule 154, a number of noteworthy differences exist. First, Rule 154 was somewhat equivocal because the word "approximately" was placed before the one percent limitation. Dropping the term "approximately" leaves little room for marginally inaccurate calculation.[128]

Secondly, in providing for the determination of the amount of outstanding securities, Rule 144 refers to "the most recent report or

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125. *See* notes 76 & 77 *supra* and accompanying text.

126. SEC Rule 144(e)(1)(A). If a Form 144 notice is required to be filed (*See* notes 146 & 147 *infra* and accompanying text), the 4 calendar weeks are counted back from the date of filing. If Form 144 is not required, they are counted from the broker's receipt of the order to execute the transaction.

127. SEC Rule 144(e)(1)(B). The Commission has noted, however, that when the automated quotation of the National Association of Securities Dealers, Inc. (NASDAQ) makes reliable volume figures publicly available, it will consider amending the rule to make the volume control the percentage amount for over-the-counter securities. Securities Act Release No. 5223 at 10 (Jan. 11, 1972).

128. Address by Herbert S. Wander, Northwestern, Mar. 27, 1972.

statement published by the issuer." Under prior law, the number of outstanding securities was calculated at the time of sale, enabling a controlling person to take advantage of the most recent issues or distributions of the issuer. This opportunity is now limited. In addition, there is some question about what constitutes "a statement published by the issuer." Has the issuer, for example, "published" a statement of the number of outstanding securities when it has filed a statement with the SEC including these figures?[129] If so, presumably it makes no difference in which of the many forms required to be filed the information appears.

Thirdly, in its provisions for determining the volume of securities traded on all exchanges, Rule 144 requires use of the average weekly volume instead of the largest weekly volume over the previous four weeks. This change was made to mitigate possible distortion of the regular trading volume caused by irregular block trading.[130] Another question that arises in the calculation of the percentage limitation of the rule is whether additional securities within the one percent limit can be sold if the volume of trading in the securities increases after the sale of what would otherwise have been the maximum one percent amount. Under Rule 154 it was possible for a controlling person to take advantage of a higher subsequent weekly volume within six months in determining the maximum amount of securities that could be sold within the one percent limitation.[131] Although the same possibility seems to exist under the language of Rule 144, the SEC staff recently has indicated that only one computation of the average weekly trading volume within a six-month period can be used,[132] and the time of that computation must be the date at which the first notice of sale[133] is filed with the Commission. The staff did indicate, however, that a moving average is being considered, which would take account of both upward and downward movement in trading volume.[134] The moving average seems to be a more reasonable approach since the purpose of the percentage limitation is only to contain the amount of securities sold in relation to the overall trading in the security. Unlike the practice under Rule 154, a security holder under Rule 144 may sell securities within the appropriate

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129. *Id.*

130. Securities Act Release No. 5223 at 10 (Jan. 11, 1972).

131. 1 L. Loss, *supra* note 9, at 2668 (Supp. 1969). If, for example, the quota on a weekly average at the time the order to sell was 25,000 shares, a controlling person sold that amount, and several months later there was a week in which the trading volume set the quota at 40,000 shares, then the controlling person could have sold an additional 15,000 during the 6-month period.

132. BNA SECURITIES REG. & LAW REP. No. 149, C-1 (Apr. 26, 1972).

133. *Id.* The moving average, however, would be designed to prevent "bootstrapping," i.e., taking advantage of increased volume caused by the seller's own prior sales.

134. *Id.*

limitation in successive six-month periods.[135] No accumulation is permitted, however; therefore, a person cannot skip six months and then sell an accumulated amount in the following six months.

2. *Determination of Amount.*—After computing the number of securities that can be sold within the appropriate one percent limitation, the seller then must determine which securities sold within the past six months (including those presently being sold) must be aggregated to determine whether the seller is remaining within the one percent limitation. For this purpose, affiliates and nonaffiliates are treated differently. In determining the amount he can presently sell under the rule, the affiliate, or controlling person, unless expressly excepted, must include all restricted and nonrestricted securities of the same class that have been sold for his account within the previous six months. For the nonaffiliate, only sales of restricted securities of the same class that have been sold for his account during the past six months are included. The nonaffiliate is free to sell any of his nonrestricted securities without regard to the rule; he remains a public investor whose sales section 4(1) was intended to exempt. For both the affiliate and the nonaffiliate, securities sold pursuant to a registration statement, under Regulation A, or under section 4(2) of the Act, are expressly excluded from the amount subject to the leakage provision.

At this point, the affiliate or nonaffiliate holder of restricted securities knows the quantity of his own sales that must be included in the present amount limitation. With this quantity, however, the rule requires the aggregation of sales by certain other persons within the same six-month period. The intention is largely to prevent a seller's use of nonsale transfers as the first step in an ultimate sale of securities in excess of the one percent amount limitation. Thus, pledgors and pledgees, donors and donees, settlors and trusts, and persons who agree to act in concert for the purpose of selling securities are required to aggregate their sales over the six-month period when computing the amount which each can sell.[136] The rule requires aggregation within six-month periods only for two years after the transfer of the securities to the donee or trust or the default of the obligation pledged by the securities. In addition to these aggregation rules, each seller should be reminded of the automatic aggregation among members of the "attribution circle" drawn by the definition of "person."

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135. Securities Act Release No. 5223 at 11 (Jan. 11, 1972). Under Rule 154 successive sales were not permitted. Securities Act Release No. 4818 (Jan. 20, 1966).

136. SEC Rule 144(e)(3)(B)-(F). For treatment of estates see notes 148-153 *infra* and accompanying text.

E. Manner of Sale

The manner of sale provision found in Rule 144(f) may be a wolf in sheep's clothing for the seller who cursorily reviews its requirement. To comply with Rule 144 both affiliates and private placees are required to sell their securities through brokers' transactions within the meaning of section 4(4) of the 1933 Act. If the seller wishes to employ a negotiated transaction to dispose of his securities, he must look elsewhere for an assurance that his sales will not constitute a distribution under section 2(11).[137] In addition to the requirement that the securities be sold in a broker's transaction, the seller under subsection (f) must not solicit or arrange for the solicitation of orders to buy the securities or make any payment in connection with the sale to any person other than the issuer. An element of the no-solicitation requirement which was not a feature of prior proposals is the Commission's insistence that brokers not publish their own quotations of the security in an inter-dealer quotation service.[138] If quotations are being made at the time a customer wishes to make a sale under the rule, the broker apparently will have to withdraw the quotation before executing the sale.

To comply with the definition of "brokers' transactions" in subsection (g) of the rule, the broker of the affiliate or private placee must do no more than execute the order to sell as an agent for the seller and may receive no more than the "usual and customary broker's commission." Like the seller, the broker cannot solicit or arrange for the solicitation of customers' orders to buy the seller's securities.[139] In addition, the broker must make "reasonable inquiry" to ensure that the seller is not an underwriter and that the sale is not part of a distribution, and, in this regard, he is deemed to know all of the information contained in the seller's Form 144 notice.[140]

The purpose of requiring the controlling persons and private placees to dispose of their securities in brokers' transactions is in large part an extension of the same purpose found in Rule 154—to ensure that the sale is not attended by the kind of activity normally associated with a

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137. *See* notes 154-198 *infra* and accompanying text.

138. Securities Act Release No. 5223 at 11 n.6 (Jan. 11, 1972). This addition has been criticized by at least one commentator as being unnecessarily strict. *See* Wander, *supra* note 82, at 960.

139. The rule permits, however, arrangements or solicitations by the broker himself of other broker-dealers who have indicated an interest in the securities within the preceding 60 days. SEC Rule 144(g)(2). The rule apparently would preclude calling back an institutional investor who has expressed interest in the securities within the last 60 days. Address by Alan Levenson, Northwestern, Mar. 27, 1972.

140. SEC Rule 144(g)(3); *see* notes 146 & 147 *infra*.

distribution. In its operation, the requirement presents several problems for the broker and seller. The normal and customary fee, to which the broker's commission is limited, for example, may pose increasing definitional difficulty as the frequency of negotiated commissions accelerates.[141] Of far greater concern to the broker, however, are the boundaries of his duty to make "reasonable inquiry." As long as he can satisfy this requirement and keep his activities in line with the remaining elements of the brokers' transactions definition, he will have ensured his exemption under section 4(4) even if the seller is subsequently found to have been engaged in a distribution in violation of section 5 of the Act.[142] Conducting a reasonable inquiry is particularly difficult because its subject, the "person . . . for whose account the securities are sold," includes all members of any "attribution circle" as well as other persons with whom the seller may be selling in concert. The broker's task in assuring the adequacy of his inquiry is somewhat eased, however, by a number of matters listed by the rule as necessary subjects of inquiry.[143] These include the length of time the securities have been held by the seller; the nature of the transaction in which the securities were acquired by the seller; the amount sold within the past six months; whether the seller intends to sell additional securities of the same class through any other means; whether the seller has done any soliciting or made any payments to any other persons; and the number of outstanding shares or the relevant trading volume. In making these inquiries, the broker will have to go beyond the assurances of his customer, but the extent to which he must independently inquire is presently unknown.[144]

Perhaps the most limiting feature of the rule's restriction on the manner of sale is the no-solicitation requirement. A holder of securities with a fairly inactive market may find it difficult to sell his securities without some solicitation. This problem is most often present for holders of over-the-counter securities.[145] Although hardship to the seller nor-

141. Announcement by William J. Casey, Chairman, SEC, Mar. 15, 1972, reported in BNA SEC. REG. LAW REP., at A-6 (Mar. 22, 1972)(setting 1974 as target for permitting negotiated commissions on block sales of securities exceeding $100,000).

142. A good argument can be made that the exemption of the broker, when a distribution has in fact occurred, is beyond the Commission's rule-making power. Note 68 *supra*.

143. SEC Rule 144(g)(3) n.2.

144. A source of information for the broker is Form 144, when it is required to be filed. An additional source has been provided by new amendments to Forms 10-K and 10-Q. These amendments require the issuer to include information both as to private placements and compliance with the periodic reporting requirements. Securities Exchange Act Releases Nos. 9442, 9443 (Jan. 10, 1972).

145. If the securities were lightly traded on a national securities exchange, the volume of tradings criteria of the percentage test may limit severely the holder's ability to dispose of his securities. SEC Rule 144(e)(1)(A).

mally can be justified because inactively traded shares are usually attended by the least public disclosure, completely prohibiting solicitation may impose too great a burden on the institutional investor who has provided needed venture capital in exchange for restricted debt securities.

F. Notice of Proposed Sale

The final condition to be met under Rule 144 is that the seller transmit a notice of his proposed sale to the Securities and Exchange Commission concurrently with the placing of a sell order.[146] The seller, however, is relieved of the notice requirement if the number of securities to be sold during any six-month period is not more than 500 shares and the aggregate sale price does not exceed 10,000 dollars. If the notice is filed and the proposed sale is not consummated within 90 days thereafter, then an amended notice must be transmitted concurrently with any future sale. Finally, the seller is required to have a bona fide intention to sell his securities within a reasonable time after filing his notice; presumably, an intention to sell within 90 days will meet this requirement.

Form 144 sets forth the kind of information that must be disclosed when the notice of proposed sale is filed. The form calls for information relating to the issuer, the person making the sale, the security being sold, the date of anticipated sale, the name of the broker completing the sale, and the exchanges upon which the securities are traded. The form also requires the information necessary to determine the seller's holding period and the amount of sales within the previous six months by the seller and other persons subject to the aggregation rules. Finally, above the seller's signature is a statement that "the person for whose account the securities . . . are to be sold . . . does not know any material adverse information in regard to the current or prospective operations of the issuer . . . ." Here again, the seller would include members of his immediate attribution circle. The extent to which this statement extends the seller's possible liability, particularly under section 10(b)-5 of the 1934 Act, is not altogether clear. Must the seller examine the issuer's recent 1934 Act reports, if any, as well as all recent public disclosures?[147] Moreover, is there a different standard for determining the knowledge of controlling and noncontrolling persons?

Form 144 seems to be the key document in the policing of the rule.

146. SEC Rule 144(h).

147. Address by Warren F. Grienenberger, Northwestern, Mar. 27, 1972.

The broker is deemed by the rule to know all that Form 144 contains, and his receipt and retention of the form is required by the rule. As a practical matter, the issuer and closely related persons are required to request receipt of the form. The form therefore becomes a significant source of common information circulated among the SEC, the broker, the issuer, and the seller. Without it, much of the rule empirically would be unenforceable.

G. *Treatment of Estates*

As a general proposition, if either an estate or the beneficiary of an estate is an affiliate, then both are subject to the same conditions as other affiliates when selling restricted or unrestricted securities. When it holds restricted securities, however, an affiliate estate is permitted to tack the holding period of the deceased to that of its own, and the beneficiaries of the estate, like those of a trust, are permitted double tacking of the holding periods of the deceased and the estate.[148] It has been noted, however, that the rule apparently does not permit the recipient to tack the holding period of a decedent when restricted securities have passed outside the probate estate, by virtue of joint tenancy, for example.[149] A further problem is present when restricted securities pass outside the probate estate to persons who were members of the attribution circle of the deceased. Will tacking be permitted even when the attributional relationship existed during only a portion of the two-year period?[150]

In the determination of the amount limitation on sales, the controlling estate is subject to aggregation rules.[151] The sales of the estate must be aggregated with those of its beneficiaries within the same six months and vice versa, and if either sells within six months of the death of the deceased, sales by the decedent also must be included. This triple aggregation is to be distinguished from the aggregation provision on trusts, under which only the sales of the settlor and the trust are aggregated. Although he enjoys the same tacking privileges as does the beneficiary of an estate, the beneficiary of a trust need not aggregate the sales of the trust or settlor within the same six-month period.[152]

If neither the estate nor its beneficiary are affiliates, the rule permits both to sell restricted securities without regard to the percentage

148. SEC Rule 144(d)(4)(G).
149. Address by Neil Flanagin, Northwestern, Mar. 27, 1972.
150. *Id.*
151. SEC Rule 144(e)(3)(E).
152. *See* SEC Rule 144(d)(4)(F), -(e)(3)(A)-(G).

limitations or the holding period requirements.[153] The only conditions to which they are subject are those relating to public information, manner of sale, and notice of proposed sales. This relaxation suggests that, in the area of nonaffiliate estates and beneficiaries, the commission is willing to reduce the public protection features of the rule and make allowances for the condition of the seller. Theoretically, the concession represents at least one change of circumstances—death—to which the Commission will give credence.

IV. Sales Outside Rule 144

Immersion in Rule 144 makes it difficult subsequently to free oneself of its specificity and assess its place in the regulation of securities under the 1933 and 1934 Acts. To a degree, this difficulty is a testament to the legislative ability of the Commission in exercising its interpretive powers. Sales of restricted and publicly acquired securities by affiliates and private placees outside of the provisions of Rule 144 are possible, and a brief discussion of the alternative paths through the thorny thicket of securities regulation seems warranted.

A. Alternative Methods of Sale by Controlling Persons

The previous presence of Rule 154 and its effective limitation on the availability of section 4(1) made the affiliate aware of alternative exemptions by which he could dispose of his securities without registration. These alternative exemptions from the registration provisions of section 5 remain essentially the same, as do their relative practical values. Available exemptions include the Regulation A offering,[154] the intrastate exemption,[155] the private placement exemption, and the direct sale exemption.

1. *Regulation A.*—Section 3(b) of the 1933 Act empowers the Commission to create an exemption "if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering."[156] Grounded in section 3(b), Regulation A[157] permits certain small public offerings by issuers and affiliates without an expensive section 5 regis-

153. SEC Rule 144(d)(4)(F) & (e)(3)(E).

154. Securities Act of 1933, 15 U.S.C. § 77c(b) (1970); SEC. Reg. A, 17 C.F.R. §§ 230.251-.262 (1971).

155. Securities Act of 1933, 15 U.S.C. § 77c(a)(11) (1970).

156. 15 U.S.C. § 77c(b) (1970).

157. SEC Reg. A, 17 CFR §§ 230.251-.262 (1971).

tration. Under the rule, as long as the total combined sales of all affiliates and the issuer do not exceed 500,000 dollars, any one affiliate can sell up to 100,000 dollars and an affiliate estate can sell up to 500,000 dollars worth of securities within a twelve-month period.[158] An affiliate can utilize Regulation A to sell restricted as well as publicly acquired securities. The specific conditions of Regulation A have been the subject of much scholarly commentary, and will not be re-examined here.[159] It is perhaps sufficient to say that registration under Regulation A provides the investor with roughly the same information that would be available if the securities were registered under section 5; however, the Regulation A procedures are less complicated and less expensive than full registration.

2. *Intrastate Exemption.*—Section 3(a)(11) exempts from registration offerings to persons resident within the state where the issuer is incorporated and is doing business.[160] To preserve the exemption, the issuer must ensure that the securities come to rest in the hands of residents of the state. If any security falls into the hands of a nonresident before coming to rest within the state the entire distribution will lose its exemption.[161] Because of the risk of inadvertent noncompliance, the exemption is of marginal value to the issuer and controlling person.

3. *Private Offering.*—A third alternative for the controlling person who desires to sell publicly acquired securities is the use of a private placement. Both a private placement and a Rule 144 sale are predicated on the controlling person's exemption under section 4(1). The Rule 144 sale is a public offering which is not a distribution by virtue of compliance with the rule's detailed conditions. The private placement is not a distribution because it is *not* a public offering. Because of the uncertainties of the application of the SEC's new definition of "distribution," however, it is uncertain whether a controlling person may privately place restricted securities. Suffice it to say that if permissible at all, the offering would have to be made in such a way as not to disturb the original private offering in which the controlling person received his restricted securities.

4. *Direct Sale.*—When selling publicly acquired securities the controlling person's loss of the section 4(1) exemption usually is attributable to the participation of a broker who becomes a statutory underwriter. It therefore theoretically is possible for the controlling person to

158. Securities Act Release No. 5225 (Jan. 10, 1972).

159. *E.g.* 1 L. Loss, *supra* note 9, at 605-34.

160. Securities Act of 1933, 15 U.S.C. § 77c(a)(11) (1970).

161. *See generally* 1 L. Loss, *supra* note 9, at 591-605.

retain the 4(1) exemption by selling publicly acquired securities directly to members of the public who purchase with investment intent without the assistance of an underwriter.[162] Although the sale would constitute a distribution, the controlling person would not himself be an underwriter under section 2(11) since he would not have purchased his securities from the issuer or another controlling person. This reasoning, however, would not support the direct sale of restricted securities by a controlling person since restricted securities, by definition, are purchased from an issuer or controlling person.

Although the "direct sale exemption" has been characterized as a "loophole" in the statutory scheme of the 1933 Act,[163] it seems practically worthless as a basis for making an unregistered distribution. Not only is it fraught with uncertainties, but it requires of the controlling person the nearly impossible task of effecting the distribution without the assistance of a broker.[164]

B. Alternative Methods of Sale by Noncontrolling Holders of Restricted Securities

Prior to the adoption of Rule 144, the private placee, assuming he had held the restricted securities for a sufficient amount of time to establish his original investment intent, was relatively free to publicly sell all his securities through his broker. For him there was no parallel to the leakage requirements placed on controlling persons by Rule 154. Consequently, the private placee was not concerned with finding alternative methods for disposing of his securities. Rule 144's continuous restriction of the resale of restricted securities, however, has stimulated the private placee's interest in alternative methods of sale.

1. *Nonexclusivity of Rule 144.*—Early drafts of Rule 144 caused some commentators to question whether the Commission's proposed perpetual restriction of the free alienability of privately placed securities had violated the constitutional guarantee of due process of law. Others expressed doubt whether the Commission possessed the statutory authority to make Rule 144 the sole method by which private placees could publicly sell their securities through brokers' transactions without registration.[165] The Commission has responded by not making Rule 144

162. 1 L. Loss, *supra* note 9, at 642-43; Clark, *SEC Regulation of Resale of Securities by Controlling Persons of Non-Reporting Issuers: The Ghost of Ira Haupt Reads the "Wheat Report" and Rule 144*, 20 DRAKE L. REV. 576, 596-97 (1971); Comment, *supra* note 22, at 485-87.

163. Cohen, *supra* note 75, at 1402.

164. Comment, *supra* note 22, at 485-87.

165. Sowards, *supra* note 59, at 526.

exclusive, but reserving comment on the question of its power to do so.[166] Thus a private placee may attempt an unregistered public sale of his securities outside the rule. The victory, however, is a pyrrhic one.

Persons who publicly offer or sell restricted securities outside the rule are "put on notice . . . that in view of the broad remedial purposes of the Act and of public policy which strongly supports registration, they will have a substantial burden of proof in establishing that an exemption . . . is available . . . and that [they] and the brokers and other persons who participate in the transactions do so *at their own risk.*"[167] If this were not a sufficient warning to daunt bold hearts, the Commission has, in addition, withdrawn a number of prior assists. The staff will no longer issue "no-action" letters relating to the resale of restricted securities.[168] It will, however, offer "interpretive letters" to assist persons in complying with the new rule. In addition, the change of circumstances doctrine has been abrogated for all sales of restricted securities. The fungibility doctrine also has been eliminated but solely for "the purpose of the rule."[169] Moreover, the Commission has reiterated its refusal to recognize any holding period outside the rule.

By the exercise of its interpretive power, the Commission has ensured practical exclusivity. Because of the ominous consequences of selling unregistered restricted securities as an underwriter, few will lightly shun the safe path through the forest to hazard noncompliance.

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166. Securities Act Release No. 5223 at 2 (Jan. 11, 1972).

167. *Id.* (emphasis added).

168. *Id.* at 12. For a brief discussion of the possible hardship on private placees of the staff's refusal to issue any more "no-action" letters in respect to resale of securities see note 40 *supra.*

169. Securities Act Release No. 5223 at 8 (Jan. 11, 1972). Limiting the nonapplicability of the fungibility doctrine to securities sold under Rule 144 is another administrative method of making Rule 144 exclusive in practice. It establishes, however, an unrealistic and indefensible double standard which cannot be justified under the statute by sound reasoning. Followed to its logical extreme, the double standard would make it impossible to sell some securities either within or without the rule. Assume that *A* owns 1,000 shares of publicly acquired stock in *X* Corporation. He later purchases 2,000 shares of the same class of stock in a private offering from *X*. *A* is a noncontrolling person. Can *A* now sell his original 1,000 shares outside Rule 144? If the nonapplicability of the fungibility doctrine is limited solely to the rule, *A* could not sell the 1,000 shares outside the rule since fungibility would cause them to bear the same taint as the privately placed securities. Can *A*, therefore, sell his 1,000 shares within the rule? Since within the confines of the rule fungibility is inapplicable, *A's* 1,000 shares are nonrestricted, noncontrol securities and, therefore, are not covered by Rule 144. Even if *A* wanted to sell the 1,000 shares within the rule, there would be no provision permitting him to do so without resurrecting the fungibility doctrine. Thus *A* becomes the victim of a gap in administrative planning created by the Commission's zealous attempt to discourage sales outside Rule 144. The only meaningful solution is for the Commission to permit *A* to sell his 1,000 shares outside the rule without restriction. This step would necessitate the complete repudiation of the fungibility doctrine, within and without Rule 144. *A* would have to maintain two pools of securities, one which could be sold freely outside Rule 144 and the second which would consist of restricted securities within the meaning of Rule 144.

The few that do so will be hard pressed to find a broker willing to risk liability and loss of license in order to assist them. The precious few who find a willing broker, however, should comply as closely as possible with the policy of the rule, particularly as related to the nature of a distribution, in order to minimize their potential liability.[170] The burden of showing the availability of an exemption is on the one seeking the exemption, and for one who has rejected the officially approved path, the burden is likely to be heavily borne. Even if the would-be seller has a strong statutory argument, he may ultimately face a court reluctant to apply the "strangulating literalism" of the statutory language, if to do so would materially compromise the Act's policy.[171]

2. *The Use of Regulation A.*—As previously noted, the controlling person is free to sell restricted securities under Regulation A. The regulation has been expanded to include expressly sales of restricted securities by nonaffiliates. Amended Regulation A permits a noncontrolling person to sell up to 100,000 dollars worth of securities within a twelve-month period as long as the aggregate of these sales by all noncontrolling persons does not exceed 500,000 dollars.[172] Moreover, these sales will not be counted towards the 500,000 dollar maximum placed on the issuer and its affiliates.[173]

The extent to which this amendment is a viable alternative to Rule 144 for the private placee is questionable, since his lack of control will make it difficult for him to persuade the issuer to undergo the abbreviated registration required by the regulation. Because only the issuer can file a registration statement under Regulation A, the Commission has encouraged private placees to negotiate for a promise that the issuer will register the securities if a later sale is desired. The private placee's lack of leverage, however, may impede his ability to bargain for such registration covenants. Even if an agreement were reached, the placee would be expected in most cases to bear much of the expense of registration. In addition, there exists some question whether, in the event of the issuer's breach, the placee could insist on specific performance of the agreement.[174]

3. *The Use of Negotiated Transactions—New Rule 237.*—A final means for the noncontrolling person to dispose of his restricted securities is provided by recently promulgated Rule 237.[175]

170. Wander, *supra* note 82, at 961.
171. *Cf.* SEC v. Harwyn Indus. Corp., 326 F. Supp. 943 (S.D.N.Y. 1971).
172. Securities Act Release No. 5225 (Jan. 10, 1972).
173. *Id.*
174. Address by Burton R. Rissman, Northwestern, Mar. 27, 1972.
175. Securities Act Release No. 5224 (Jan. 10, 1972).

Adopted under section 3(b) of the 1933 Act,[176] Rule 237 exempts from section 5[177] privately negotiated resales of restricted securities by persons other than the issuer, controlling persons, or broker-dealers, if four conditions are satisfied: (1) the issuer is a domestic organization; (2) the issuer has at least a five-year active business history; (3) the securities sold have been beneficially owned and fully paid for, if purchased, for at least five years prior to sale; (4) the securities are sold in a bona fide negotiated transaction otherwise than through a broker or dealer. In contrast to the provisions of Rule 144(d)(2),[178] Rule 237's "full purchase price" requirement does not provide for payments by promissory notes or other obligations. Under Rule 237, therefore, the full purchase price is not deemed to have been paid, and hence the five-year holding period does not start until such obligations have been fully paid.[179] In addition, Rule 237(b) imposes a quantitative limit on the amount of securities that can be sold in negotiated transactions. Sales under the rule cannot exceed in any *one year* period "the lesser of the gross proceeds from the sale of one percent of the securities of the class outstanding or 50,000 dollars in aggregate gross proceeds."[180] In determining the amount of securities that can be sold in any year under Rule 237, sales pursuant to Regulation A and sales under Rule 144 are aggregated.[181] At least ten days beforc the sale a Form 237 Notice of Proposed Sale must be filed with the Regional Office of the Commission for the region where the issuer's principal business is conducted. The purchaser of restricted securities under Rule 237 acquires stock that is no longer restricted.[182]

Rule 237 provides an exemption for the noncontrolling person who owns restricted securities when the issuer does not satisfy all of the

176. Securities Act of 1933, § 3(b), 15 U.S.C. § 77c(b)(1970).

177. It should be noted that the rule does not exempt the sales from the antifraud provisions of the securities acts. Securities Act Release No. 5224 (Jan. 10, 1972).

178. *See* note 105 *supra* and accompanying text.

179. SEC Rule 237(a)(3), Securities Act Release No. 5224 (Jan. 10, 1972).

180. *Id.* at 237(b).

181. SEC Rule 237(b). Compare this provision with Rule 144(e)(3)(G), which provides that securities sold under Regulation A or in a private offering under § 4(2) are not aggregated for purposes of determining the amount of securities that can be sold under Rule 144. Moreover, there is no express requirement that Rule 237 sales be aggregated with Rule 144 sales in determining the amount of restricted securities that can be sold under Rule 144 by a noncontrolling seller. The wording of Rule 237(b)'s aggregation requirement for "securities sold during such year pursuant to any other exemption under section 3(b) . . . ." fails to limit the aggregation to securities of the same class or even securities of the same issuer. When contrasted with the remainder of the sentence, which aggregates only "securities *of the same class* sold in reliance upon Rule 144," the omission would seem to impose a harsh requirement on holders of restricted securities who have sold securities under Regulation A during the same one-year period.

182. Securities Act Release No. 5224 (Jan. 10, 1972).

conditions of Rule 144. The Commission's objective is to avoid unduly restricting the liquidity of these investments. Implicitly, Rule 237 is a recognition of the practical exclusivity of Rule 144 and represents an effort to give some relief to the private placee.

C. Sales Following Reclassifications, Mergers, Consolidations, and Sales of Assets—Proposed Rule 145

A full exposition of the "no-sale" theory of Rule 133 is beyond the scope of this inquiry;[183] the adoption of Rule 144, however, has forced some changes in the operation of Rule 133, principally in the interrelationship of the leakage provisions of the two rules, which should be considered. Under what circumstances must the former shareholder of the constituent or acquired corporation who wishes to sell newly acquired securities in the surviving enterprise comply with the provisions of Rule 144, and under what circumstances must he comply with Rule 133? In an attempt to dispel mounting confusion, the SEC recently has proposed new Rule 145,[184] designed to replace present Rule 133.[185]

1. *Interlacing of Rule 133 and Rule 144.*—Rule 133 provides that for purposes of section 5,[186] no "sale," "offer to sell," or "offer for sale" is deemed to have occurred when a plan for certain reclassifications,[187] mergers, consolidations, or sales of assets in exchange for stock of the acquiring corporation is submitted to the shareholders of the constituent

183. The theory has received extensive comment elsewhere. *See generally* 1 L. LOSS, *supra* note 9, at 518-42; WHEAT REPORT, *supra* note 4, at 251-96; Comment, *Recent Developments in the No-Sale Theory Under the Securities Act of 1933: Proposed Revision of Rule 133*, 47 CALIF. L. REV. 112 (1959); Purcell, *A Consideration of the "No-Sale" Theory Under the Securities Act of 1933*, 24 BROOKLYN L. REV. 254 (1958); Sargent, *A Review of the "No-Sale" Theory of Rule 133*, 13 BUS. LAW. 78 (1957); Sommer, *Mergers, Consolidations, Sales of Assets—Rule 133*, 16 WEST. RES. L. REV. 11 (1964).

184. Securities Act Release No. 5246 (May 2, 1972).

185. *Id.*

186. Rule 133's "no-sale" theory does not apply to the antifraud provisions of the 1933 and 1934 acts. SEC v. National Securities, Inc., 393 U.S. 453 (1969); 1 L. LOSS, *supra* note 9, at 524-28.

187. There are 3 kinds of reclassifications: (1) those accomplished by the solicitation of security holders to voluntarily exchange their securities for reclassified securities; (2) those resulting from a reorganization either under the Bankruptcy Act or under corresponding state law; and (3) those accomplished by amendment of the corporate charter. Rule 133 does not address the first 2 kinds, which are generally exempt from § 5 by either § 3(a)(10) or § 3(a)(11) of the Act. Section 3(a)(9) exempts reclassifications of the third variety if no paid solicitors are used. If paid solicitors are used, the reclassification may still be exempt under § 3(a)(10). Rule 133 is limited to those reclassifications in the third category and is available for reclassifications of the third category that are not otherwise exempt and are executed pursuant to a plan that relates to corporate stock and is required to be submitted to a vote of the shareholders. WHEAT REPORT, *supra* note 4, at 288-91.

corporation or of the corporation reclassifying its securities.[188] The rule, therefore, provides an effective exemption from registration for securities issued in a reorganization but not for their subsequent sale by shareholders. In the case of a merger, consolidation or asset sale, the shareholders can be classified as follows: (1) Shareholders who are controlling persons of the constituent corporation but who do not become controlling persons of the acquiring corporation; (2) shareholders who are controlling persons of the constituent company and who become controlling persons in the surviving enterprise; (3) noncontrolling shareholders who held privately placed securities in the constituent corporation which were exchanged for securities of the acquiring corporation; or (4) noncontrolling shareholders who held publicly acquired securities of the constituent corporation which were exchanged for securities of the acquiring corporation.

A shareholder within the first category, who was a controlling person of the constituent company but who does not become a controlling person of the surviving enterprise is deemed to be a statutory underwriter if the securities of the issuer are acquired with a view to distribution.[189] Thus, the shareholder must take the securities of the acquiring corporation with an investment intent and retain the securities for a holding period commensurate with that intent. After the original investment intent is demonstrated, the controlling person of the constituent corporation would be as free to sell all his securities under section 4(1) as other noncontrolling persons of the acquiring corporation. In addition, during the holding period, Rule 133(d) provides for leakage sales under a one percent scheme similar to that contained in rescinded Rule 154.[190] The purpose of these provisions is to place the controlling person of the constituent corporation in essentially the same position before and after the Rule 133 transaction.[191] Before the adoption of Rule 144, this objective substantially was achieved by the parallel structures of the

188. SEC Rule 133, 17 C.F.R. § 230.133(a) (1971).

189. *Id.*, § 230.133(c).

190. *Id.*, § 230.133(d).

191. There is a distinction between the statutory bases upon which a controlling person of a constituent corporation and a controlling person of the issuer are subject to loss of their § 4(1) exemptions. Rule 133 permits the controlling person of the constituent corporation to make limited sales without becoming a statutory underwriter. If the controlling person of the constituent corporation sells his newly acquired securities without complying with Rule 133, he will be deemed to have acquired the securities from the issuer in a nonregistered transaction with a view to distribution. On the other hand, the controlling person of the issuer is concerned with his broker, and not himself, becoming a statutory underwriter. If his broker becomes an underwriter, then the controlling person will lose his § 4(1) exemption because of his broker's involvement in the sale. *See* notes 57 & 58 *supra* and accompanying text.

Rule 154 and Rule 133 leakage provisions. The adoption of Rule 144, however, has destroyed this parallelism and has created a disequilibrium that will continue as long as Rule 133 remains in effect.

A shareholder within the second category, who was a controlling person of the constituent corporation and who becomes a controlling person of the issuer also is deemed to be a statutory underwriter by Rule 133(c) if the securities are taken with a view to distribution. That he is now a controlling person of the issuer, however, places him in a different position from the shareholder in the first category. The shareholder in the second category is covered by the leakage provisions of Rule 133(d) and Rule 144. This should be one instance in which the nonexclusivity of Rule 144 is practically meaningful, for the controlling person should be able to opt for the more relaxed requirements of Rule 133.

A shareholder in the third category, who exchanges restricted securities for securities of the issuer, holds the new securities subject to the same restrictions that attached to his restricted securities in the constituent corporation.[192] Rule 144, however, does not provide specifically for tacking of the holding periods of the securities given up and the securities received in the transaction. This omission should not prevent the shareholder from tacking since tacking appears necessary to accomplish the regulatory objective of placing him in the same position after the Rule 133 transaction as he was previously.

A shareholder who falls within the fourth category—who exchanges publicly acquired securities in the constitutent corporation for securities in the surviving corporation—is as free to sell his newly acquired securities under section 4(1) as he was prior to the reorganization. Rule 133(c) is not addressed to noncontrolling shareholders of the constituent corporation; therefore he has no fear of becoming a statutory underwriter.

2. *Proposed Rule 145.*—In response to longstanding dissatisfaction with the "no-sale" concept of Rule 133 and to the newly created need for elimination of the disparities between Rule 144 and Rule 133, the Commission recently has proposed Rule 145[193] and a number of related rules and amendments.[194] The proposed rule would abolish the

192. Address by Donald Schwartz, Northwestern, Mar. 27, 1972.

193. Securities Act Release No. 5246 (May 2, 1972).

194. Related proposals include Proposed Rule 153A (defining "preceded by a prospectus" in section 5(b)(2) as "the sending of a prospectus, prior to the vote of security holders . . . to all security holders of record . . . entitled to vote"); Proposed Revisions of Form S-14 (providing a "wrap around" prospectus in the form of a proxy meeting the requirements of § 14 of the Exchange Act); Proposed Amendment of Rule 14a-2(d) under the Exchange Act (providing that the exemption from the proxy rules does not apply to solicitations involved in a Rule 145-type transaction);

"no-sale" concept and therefore would require an issuer in an otherwise nonexempt reclassification, merger, consolidation, or sale of assets in exchange for securities to undergo registration. To this extent the proposed rule is consistent with prior proposals.[195] The proposal goes on, however, to impose an unprecedented restriction on resales by shareholders who receive securities of the issuer. Under the proposed rule, any shareholder, whcther or not in control of the constituent corporation, who takes more than a set percentage amount of securities in the surviving enterprise—roughly the same percentage set out in Rule 144(e)[196]—is deemed to be an underwriter if he offers or sells the registered securities acquired in a Rule 145 transaction. The only exemption for such shareholder is a sale in accordance with the provisions of Rule 144(c) (Current Public Information), (e) (Limitation on Amount of Securities Sold), (f) (Manner of Sale), and (g) (Brokers' Transactions), in which case the proposed rule provides that the shareholder will not be deemed a statutory underwriter.

Although one apparent intention of proposed Rule 145 is to ensure public protection by bringing more sellers within the requirements of Rule 144, the wisdom of the rule's restrictions and even the power of the Commission to impose them are questionable. The 1933 Act was never intended to inhibit the free and open trading of securities received by noncontrolling persons pursuant to a registered public offering.[197] Although a literal reading of section 2(11) might support the finding of underwriter status for such persons, this sort of interpretation was clearly not intended. The imposition of the restrictions of Rule 144(c), (e), (f) and (g) on noncontrolling persons who are not private placees is an unprecedented restriction on the alienability of securities.

To the extent that Rule 145 is an effort to establish the same

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and Proposed Amendment of Rule 14a-6 under the Exchange Act (providing that both the proxy rules and the registration requirements will apply to material filed with respect to Rule 145 transactions). Securities Act Release No. 5246 (May 2, 1972).

195. Securities Act Release No. 5012 (Oct. 9, 1969).

196. The percentage amount is described as follows:

(1) If securities of the same class are admitted to trading on a national securities exchange, the lesser of (A) one percent of the shares or other units of the class outstanding as shown by the registration statement, or (B) the average weekly reported volume of trading in such securities on all securities exchanges during the 4 calendar weeks preceding the effective date of such statement;

(2) If securities of the same class are not traded on a national securities exchange but are traded in the over-the-counter market, one percent of the shares or other units of the class outstanding as shown by the registration statement; or

(3) If on the effective date of the registration statement there is no public trading market for the securities of the class covered by the registration statement, 5% of the shares of other units of such class registered. Proposed Rule 145(c). Securities Act Release No. 5246 (May 2, 1972).

197. *See* notes 10-12 *supra* and accompanying text.

equilibrium between Rule 145 and Rule 144 that previously existed between Rule 133 and Rule 154, the rule goes much further than is necessary. In explaining the leakage provisions of Rule 133 and their relationship to Rule 154, the Commission stated that "in a situation where a trading market may be availed of by other persons receiving securities in a Rule 133 transaction, it would be less than realistic to permit a controlling person of a constituent company less latitude in a trading transaction than he had before consummation of the Rule 133 transaction and, and indeed, less than a controlling person of the issuer itself."[198] Rule 145 clearly violates the spirit of this reasoning by permitting the noncontrolling security holder of the constituent corporation far less latitude after the Rule 145 transaction than he had prior to the transaction. Indeed, the noncontrolling person of the constituent corporation may have less latitude than the noncontrolling person of the acquiring corporation although sales by either person present the same risk to the investor.

V. Evaluation

Rule 144 heralds a dramatic change in the treatment of resales by private placees and to a lesser degree resales by controlling persons. It also has introduced a more thorough mechanism for enforcement. That mechanism makes possible a monitoring of the gradual flow of privately placed and control securities to the public. The effectiveness of this system rests upon the interdependence of the issuer, the broker, and the seller in securing their several exemptions. The key instrument is Form 144, which each of the parties has a substantial interest in having circulated among themselves. When the activity of any one of the parties triggers the objective scrutiny of another, the activity becomes more visible and enforcement of the rule is more effective. On the other hand, when the activities of any party are not monitored, enforcement of the rule is more difficult. It is, for example, difficult for a broker to discover if a private placee properly has accounted for tolling periods in which the placee has had shorts or puts outstanding. The responsibility for making tolling adjustments is on the seller alone and his failure to do so may suffer from low visibility. Similarly, the prohibition against solicitation poses serious enforcement problems, since a solicited buyer may well be willing to sign a statement at the time of the sale that he was not solicited.

The most innovative element of Rule 144 is its imposition of a

198. Securities Act Release No. 4248 (1960).

permanent restriction on the public resale of privately placed securities. This feature of the rule, more than any other, raises the question of the Commission's power as the administrative agency of the Securities Act. Reduced to its simplest form, Rule 144 has altered the position of the private placee within the statutory framework by a reinterpretation of section 2(11). By the shift of interpretive emphasis from "view to" to a newly defined "distribution," the Commission has completely reconstructed the statutory scheme of the 1933 Act as it bears on resales by private placees. The change is so fundamental that it is difficult to characterize Rule 144 as anything other than administrative legislation. It is at least questionable whether Congress intended the power to define terms within the Act to be a springboard for such expansive legislative action. The case might be different if the new definition of "distribution" were reasonably within the context of section 2(11). Arguably, however, it is not, when applied to the private placee. In imposing a permanent restriction on the private placee, the rule fails to recognize that a statutorily required relationship between an issuer and the person making a distribution must exist before that person can be characterized as a statutory underwriter. Section 2(11) requires that a person take from an issuer with a view to distribution, offer or sell *for an issuer,* or participate in any such undertaking. The section does not say that anyone who makes a "distribution" at any point in the future is an underwriter. A private placee who has fully paid for his securities and has held them for ten years before publicly selling could hardly be said to be selling those securities "for the issuer." Nor could it realistically be said that he took with a "view to" distribution. If the securities sold are in excess of the one percent quota, however, the practical exclusivity of Rule 144 creates the distinct possibility that the seller will be labeled a statutory underwriter under section 2(11). On the other hand, the underlying policy objectives of Rule 144 essentially are sound. The rule partially satisfies the recognized need for a continuous disclosure system through the integration of the 1933 and 1934 Acts. It is highly unlikely, therefore, that any court will find that the Commission has exceeded its statutory power in promulgating Rule 144. The Commission nevertheless should be conscious of the effect that these new restrictions on privâte placements will have, and if experience shows the rule to be too restrictive, the Commission should be prompt in seeking remedial measures. One industry that may be restricted excessively is that of institutional investors, who receive a large amount of debt securities through private offerings.[199] For these private placees, the rule's permis-

199. Note 9 *supra.*

sion to sell one percent of a class of debt securities in an unsolicited broker's transaction is no permission at all if the securities are thinly traded, as they usually are. This predicament has caused one commentator to suggest that when applied to the resale of privately placed debt securities, the limitations imposed by the one percent rule "render the Rule useless as it stands."[200] If this statement proves to be correct, Rule 144 will have a substantially detrimental effect on small corporations that long have relied upon the private placement of debt securities as a primary method of raising needed capital.

Finally, it should be noted that in its effort to be concise the Commission may have risked some of the beneficial flexibility afforded by prior vagaries. It is possible, for example, that the rule's provisions relating to donees and trust beneficiaries could be utilized to violate the spirit of the rule.[201] In anticipation of such conduct, the release announcing Rule 144 provides that "the rule shall not be available to any individual or entity with respect to any transaction which, *although in technical compliance with the provisions of the rule,* is part of a plan by such individual or entity to distribute or redistribute securities to the public."[202] If used with proper restraint, this clause could provide needed flexibility. If used immoderately, it could destroy confidence in the workability of the rule and restore previous confusion.

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200. Address by Adrian Leiby, Saloman Brothers, Seminar on Private Placements, Nov. 17, 1971. The remarks by Mr. Leiby were addressed to Proposed Rule 144. The one percent feature of the proposed rule, however, remains the same.

201. The aggregation provision relating to donees requires the grouping of amounts sold by the donor and the donee. It does not require aggregation among donees. It would be possible, therefore, for a single donee to give one percent to each of a number of donees who could then resell their entire amount so long as they do not act in concert. Rule 144 (a)(3)(C). Similarly, aggregation when applied to trusts is operative only between the settlor and the trust and does not include sales by beneficiaries of the trust. Rule 144(e)(3)(D).

202. Securities Act Release 5223, at 13 (Jan. 11, 1972).