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I. INTRODUCTION

In November, 1967, the Securities and Exchange Commission (hereinafter cited as the SEC or Commission) announced the formation of a small internal study group under the direction of Commissioner Francis M. Wheat. The Commission's action in initiating this study was prompted in part by a growing dissatisfaction with the operation of the disclosure requirements of the Securities Act of 1933[1] and the failure of that Act, as currently interpreted and administered by the Commission, to provide a meaningful degree of certainty and predictability in its application. In establishing the Study Group, the Commission stated that its purpose would be to "inquire into means for improving the administration and enforcement of the disclosure requirements of the [1933 and 1934] Acts and dissemination to the investing public of information material to investment decisions."[2] In April 1969, the Commission's Study Group released what is currently referred to as the Wheat Report.[3]

Due to the modest size of the Study Group,[4] the Wheat Report deals only with a limited area of federal securities regulation and does not cover various specialized aspects of disclosure policy, such as disclosures required by the Investment Company Act, the Public Utility Holding Company Act, or the Trust Indenture Act. Furthermore, the Wheat Report does not deal with those questions which have recently

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1. 15 U.S.C. § 77(a)-(aa) (1964) [hereinafter cited as the Securities Act or the 1933 Act].

2. SEC Securities Act Release No. 4885 (Nov. 29, 1967).

3. SEC DISCLOSURE TO INVESTORS, A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (CCH 1969) [hereinafter cited as the Wheat Report].

4. For a portion of the last fourteen months, five persons were involved full time in the work of the Study; for the balance of that period, four persons were so engaged. One member of the Commission's staff acted as a senior adviser to the Study and others contributed assistance in particular areas.

excited great interest, such as the obligation of the so-called "insiders" to make appropriate disclosures of unpublished material information in connection with their purchases and sales of securities. Instead, the primary goals of the study were:

> to discover what could be done through the rule-making process—
> (a) to enhance the degree of coordination between the disclosures required by the '33 and "34 Acts;
> (b) to respond to the call for greater certainty and predictability; and
> (c) to develop a consistent interpretive pattern which would help to assure that appropriate disclosures are made prior to the creation of interstate public markets in the securities of any issuer.[5]

Fully recognizing the Study Group's emphasis on the importance of amplifying the reporting requirements of the Securities Exchange Act of 1934[6] and integrating them with the regulations of the 1933 Act, it seems to lawyers in the Securities field, that Chapter VI, entitled Secondary Distributions and Brokers' Transactions, is the heart of the Wheat Report. Chapter VI proposes "definitional rules" dealing in the main with resales by persons who have purchased securities "from the issuer or from a controlling person" in so-called "private placements." These rules are at variance with long-standing interpretations of statutory language[7] under which an "investment-intent" on the part of the purchaser, coupled with a limited number of offerees, has provided the basis for a private offering exemption. According to these traditional interpretations, resales by such a purchaser have been permissible only after some indeterminate lapse of time or if and when the purchaser is fortunate enough to experience a "change of circumstances."

It is the purpose of this article to state the existing law with regard to the resale of privately placed securities and then to consider the proposals in Chapter VI of the Wheat Report. Special emphasis will be given to the doctrines of "investment intent" and "change of circumstances" to show the state of confusion which precipitated the need for the new rules.

II. THE STATE OF CONFUSION

A. *The Private Placement Exemption*

The Securities Act of 1933 is generally identified with the registration of securities with the SEC and the attendant disclosure for primary and secondary offerings. The legislative purpose behind the registration

5. Wheat Report, at 8.
6. 15 U.S.C. 78(a)-(jj) (1964) [hereinafter cited as the Exchange Act or the 1934 Act].
7. *See* Wheat Report, at 152.

requirement was to protect the investing public through the disclosures and by creating certain liabilities for a noncomplying registration or distribution (but not the trading) of securities. The important thing that Congress had in mind was to make sure that, in the future, the public should have free access to all relevant financial information concerning the great numbers of securities that each year were coming onto the market.[8]

When Congress passed the Securities Act of 1933, an exemption from registration was placed in the second clause of section 4(1)[now section 4(2)] for "transactions by an issuer not involving any public offering."[9] That is, "privately placed" securities were excused from registration. This exemption, was not thought by anyone to be significant; at most it was believed that only a relatively few securities would be so issued, and those to persons already fully conversant with the issuer's business.[10] But the exemption, "insignificant" in 1933, soon took on substantial proportions. During the next four years, 1934-1937, securities with an aggregate value of more than a billion dollars were issued without registration.[11] Under this exemption which was designed for an "isolated sale to a particular person," $10.1 billion of securities were sold for cash in 2,613 private offerings during the three calendar years 1951, 1953 and 1955.[12] With the increase in its use, the exemption became more and more controversial and doubts arose as to what constituted a "private offering" vis a vis a "public offering."

Much of the controversy arose because the Securities Act had no description of what constituted a "public offering."[13] Nor did the legislative history throw much meaning on the term used in section 4(1). The House report merely states that it "exempts transactions . . . to permit an issuer to make a specific or an isolated sale of its securities to a particular person," but required "that if a sale of the issuer's securities should be made generally to the public that the transaction shall come within the purview of the Act."[14] A later House and Senate Conference

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

9. 15 U.S.C. § 77(d)(1) (1964). The text of Section 77(d)(1), relating to exempted transactions, reads in part as follows: "The provisions of Section 77(e) of this title [which provides generally for registration] shall not apply to any of the following transactions: (1) Transactions by any person other than an insurer, underwriter, or dealer; transactions by an issuer not involving any public offering; . . . ."

10. There was a dearth of comment as to the scope of the exemption when the act was being debated. Arthur H. Dean, in a general discussion said merely that: "Transactions between private persons, not with a view to public offering, are exempt." Fortune, Aug. 1933, at 55.

11. 26 S.E.C. ANN. REP. 244 (1960); 1960 MOODY'S IND. MANUAL, Special Features Section, at 19.

12. SEC, COST OF FLOTATION OF CORPORATE SECURITIES 1951-1955, at 25 (1957).

13. The term came up in United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953), it being a government contention that the Securities Act referred to "one general offering for only a limited period. . . ."

14. H.R. Rep. No. 85, 73d Cong., 1st Sess. 15, 16 (1933). *See also* S. Rep. No. 47, 73d Cong., 1st Sess. (1933).

report contains the following language: "Sales of stock to stockholders become subject to the Act unless the stockholders are so small in number that the sale to them does not constitute a public offering."[15] Congress, however, did not draw a line at the illusive point where a transaction creases to be private and becomes a public offering. At the time the 1933 Act became law, there was nothing to suggest that private placements were ever made to more than a few persons; and nothing whatever to indicate that Congress considered the possibility that in the next quarter century, such placements might be made in an amount aggregating over fifty billion dollars.[16]

Nevertheless, the private offering exemption provided a means to escape the publicity and burdens of registration, and the financial community was not slow to take advantage of it. Counsel for the Commission was soon called on to give a comprehensive opinion in the matter. In his view—and his opinion has set Commission policy since—the scope of the exemption was "essentially a question of fact,"[17] in which a number of circumstances were pertinent; for example: the number of offerees; their relationship to each other; the number of units offered; and the type and size of the offering.

The Commissioner's construction of the section 4(1) exemption was by no means unwelcome to investors who found they could easily tailor operations to come within the exemption. However, those selling under the exemption came against another grey area which was to prove most troublesome in future years. Even though all other conditions were satisfied, the exemption was lost if the purchaser took "with a view to distribution." The reason for this is that the 1933 Act defines "underwriter" as a "person who has purchased . . . with a view to, . . . or sells . . . in connection with, the distribution of any security . . . ."[18] The requirement that the purchase be for investment and not with a view to distribution[19] *i.e.*, a purchaser with "investment intent", is quite logical. Its purpose is to prevent private sales from being converted into public distributions by using the original purchasers as conduits.[20] Not so logical, however, was the fact that "investment intent" was not defined by the 1933 Act or any rule of the Commission in terms of a definite holding period. In short, even if a company used the "private placement" exemption, investors were sure to ask: "How long do I have to hold?"

15. H.R. Rep. No. 152, 73d Cong., 1st Sess. 25 (1933).

16. *Hearings Before the Subcommittee of the House Committee on Interstate and Foreign Commerce*, 82d Cong., 2d Sess. 127 (1952). The Committee's conclusion on H.R. 2508, 82d Cong., 2d Sess. (1952), was that: "The Congress therefore could not have foreseen the developments to date when tremendous bond offerings amounting to billions of dollars each year, and totalling over 22 billion dollars since 1934, are not being registered." *Id.*

17. SEC Securities Act Release No. 285 (Jan. 24, 1935).

18. 15 U.S.C. § 77(b)(11) (1964).

19. SEC Securities Act Release No. 4552 (Nov. 6, 1962).

20. *See* Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825 (Aug. 12, 1957).

Until the Wheat Report, no one could give the answer to this logical question.[21]

B. *The Holding Period*

Minimally, it seems today that a private offering can be undertaken if the securities sold are purchased by an investor who signs an investment letter representing that: (1) he is holding for investment; (2) that the securities are marked with a legend which specifically and clearly states that they are not free stock but were sold pursuant to such investment representation; and (3) if the issuer notifies the transfer agent and gives specific instructions not to permit transfer of the securities unless an SEC "no-action" letter is obtained or an opinion of competent counsel states that the securities are free for sale. Translating all of this in terms of section 4(2), an issuer when making a private offering, must make sure that the securities sold do not get back into the stream of commerce for at least a period consonant with an investment intention, and inconsonant with an intention to make a distribution.

Many different holding periods with a spread between six months and five years have been suggested, but none could be given with any assurance. The SEC recognizes no fixed time period between purchase and sale as establishing an investment intent, although it does acknowledge that the passing of time is an important factor.[22] Certainly the concept of "purchase for investment" never included any holding period analogous to the six months required under the Internal Revenue Code to establish long term gains. Until a few years ago, a one-year rule of thumb had evolved among the securities-law bar. In a 1938 opinion of General Counsel he expressed the view that retention of the securities for as long as a year would "create a strong inference that they had been purchased for investment."[23] He added, however, that even such an inference would fall, for example, "in the face of evidence of a prearranged scheme to effect a distribution at the end of the year."[24]

The Commission's most elaborate exposition of the resale problem under the private offering exemption resulted from the sale of $4 million of convertible debentures by Crowell-Collier Publishing Company in 1955 and 1956. In its opinion in the *Crowell-Collier* case[25] the Commission observed that "holding for a year, does not afford a statutory basis for an exemption . . . ." Other pronouncements on this subject by the Commission and its staff furnish little additional information. For example, in the *Crowell-Collier* release and the Second Circuit's decision

21. *See* Sowards, *The Wheat Report and Reform of Federal Securities Regulations*, 23 VAND. L. REV. 495, 504 (1970).

22. SEC Securities Act Release No. 4552 (Nov. 6, 1962).

23. Op. Gen. Counsel, SEC Securities Act Release No. 1862 (Dec. 13, 1938).

24. *Id.*

25. Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825, at 7 (Aug. 12, 1957).

in the related case of *Gilligan, Will & Co. v. SEC*,[26] it was stipulated that a ten-month holding period did not preclude a finding of intent to distribute. Subsequently, former Chairman Cohen (then Commissioner) remarked that a presumption of investment intent might arise after a two-year holding period. One author clearly indicated, however, that certain kinds of factual situations would negate any such presumption, despite the period of holding.[27]

In *United States v. Sherwood*,[28] the Court stated that the presence of a two-year holding period was "an insuperable obstacle"[29] to finding an intent to distribute. *Sherwood*, however, was a criminal contempt case in which the Government had the burden of establishing distributive intent beyond a reasonable doubt. In the normal case, where the seller has the burden of establishing his investment intent by a preponderance of the evidence, the *Sherwood* case would not be of much value. Another opinion on the subject by an experienced private practitioner demonstrates still another viewpoint as to the length of the holding period.

> As a practical matter, the shares may . . . be sold in any manner after the lapse of a sufficient amount of time, the period being rather indefinite but *probably two to three years*. For the record, however, it is official dogma that if stock is acquired for investment, a lapse of time (no matter how long) does not automatically free the stock from restrictions on resale.[30]

Finally, in certain cases, the Commission has advised investors who held privately placed debt securities that resale could be made only after five years.[31] From the foregoing, it is difficult to see how a resale could ever be made with safety except in the event of a no-action letter or some personal disaster such as death or bankruptcy.[32]

Because of the lack of any fixed holding period or reliable rule of thumb, purchasers who sign letters of investment intent have been responsible for the great bulk of the interpretative requests and requests for "no action" letters received by the Division of Corporate Finance.[33] Present interpretations are keyed to the necessity of asserting, and then demonstrating, a state of mind on the part of the private purchasers. The test for claiming an exemption from the registration requirements is subjective. Since direct evidence of the seller's intent is rarely available,

26. 267 F.2d 461, 468 (2d Cir. 1959); SEC Securities Act Release No. 4248 (July 14, 1960), in which the Commission, in its proposed rule 155, declined to adopt any prima facie holding period preceding the sale of underlying securities received upon conversion.

27. SEC, PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS, 30, 31 (C. Isreals ed. 1962).

28. 175 F. Supp. 480 (S.D.N.Y. 1959).

29. *Id.* at 483.

30. Schneider, *Acquisitions Under the Federal Securities Laws—A Program for Reform*, 116 U. PA. L. REV. 1323, 1337 (1968) (emphasis added).

31. Wheat Report, at 165.

32. I L. LOSS, SECURITIES REGULATIONS 165 (2d ed. 1961).

33. Wheat Report, at 156.

appearances have formed the basis for controlling inferences. The holding period will support or negate an investment intent depending on two factors: circumstances at the time of purchase and intervening changes in circumstances ("Change of circumstances" doctrine).

C. *Change Of Circumstances*

Regardless of the emphasis given to the period of holding, the Commission has long conceded that an unforeseen and unforeseeable "material" change of circumstances, either in the situation of the security purchaser or of the issuer, may release a purchaser at any time from his commitment. This concession is based on the theory that such a change justifies the inference of a change of a proper intent previously existing.[34] It is not every change of circumstances, however, which is effective. Among the changes which the Commission does not consider sufficient are these: (1) any change reasonably foreseeable at the time of the purchase, e.g., heavy expenditures needed in the purchaser's business; (2) change induced by the purchaser's own conduct, as for instance, purchase of any expensive home requiring liquidation of the investment to gain funds for the down payment or need to sell the security to pay off a loan incurred on its purchase; or (3) change in the general fortunes of the issuer, as, for instance, losses, decline in the market, or loss of an important account.

Among the changes considered sufficient are: (1) unforeseen serious illness in the purchaser's family resulting in large medical expenses; (2) a radical change in the nature of the issuers business, e.g., a change from the mining of coal to the manufacture of electric parts; or (3) nearly complete turnover in the management of the issuer.[35]

Tying this in with the holding period requirement, the substantiality of the required "change of circumstances" varies directly with the length of time between purchase and sale. As stated by one commentator, "prudent counsel would prefer to see the passage of at least two years as partial basis for his opinion that sale may be made because of a change in circumstances which was not contemplated at the time the security was originally acquired."[36]

Once again, rules which give certainty and predictability have not materialized. The "change in circumstances" doctrine has instead been decided on a case by case basis.

III. The Theory Behind the Proposed Rules

The Supreme Court in the *Ralston Purina*[37] case stated that the question of whether an offering constitutes a public offering or is exempt

34. SEC Securities Act Release No. 4552 (Nov. 6, 1962).
35. *See* Isreals, *Some Commercial Overtones of Private Placement*, 45 VA. L. REV. 851 (1959); Victor & Bedrick, *Private Offering: Hazards for the Unwary*, 45 VA. L. REV. 869 (1959).
36. WHEN CORPORATIONS GO PUBLIC (C. Isreals & G. Duff, Jr., eds. 1962) at 15.
37. S.E.C. v. Ralston Purina Co., 346 U.S. 119 (1953).

from registration as a private offering turns "on the need of the offerees for the protections afforded by registration."[38] Where the offerees are not shown to have access to the kind of information which registration would disclose, compliance with section 5 of the Securities Act is required. Both the "change of circumstances" doctrine and the holding requirement arose from the need to find ways of deterring the flow of securities from issuers to the public without registration, yet both concepts are non-functional in that they bear no relation to the needs of investors. In order to lay the framework for a functional disclosure system, the Study Group first had to resolve the question: under what circumstances do investors need the protection of registration when securities held by a controlling person are sold, or when securities sold privately by the issuer are resold?

Reporting vs. Non-Reporting Companies

It was concluded in the Wheat Report that the best answer to this question could be found by drawing a distinction between companies which file regular reports of their affairs with the Commission under sections 13[39] or 15(d)[40] of the 1934 Act ("reporting companies") and companies which do not file such reports ("non-reporting companies"). Under this system, if there is not full disclosure of a company's business, earnings, and financial condition (or if the company is a reporting company and its reports appear to be out of date), a sale to the public of that company's securities ought to be accompanied by the disclosures afforded by registration under the 1933 Act. On the other hand, if a company has registered a class of its securities with the Commission under the 1934 Act, and is keeping current the information in the original registration statement through up-to-date periodic reports to the Commission, then it ought to be possible to permit secondary sales of its securities to the public without the filing of 1933 Act registration statement. There would be exceptions in the latter case:

> (1) where the quantity of those securities to be sold exceed the amount which the trading market normally could be expected to absorb within a reasonable period of time, or
>
> (2) where, in order to move the securities from private into public hands, arrangements for the solicitation of buying

38. *Id.* at 127.

39. Section 13 of the Exchange Act requires a listed company to keep reasonably current, the information contained in the application for registration and to file annual and periodic reports. Exchange Act, 15 U.S.C. § 78(m) (1964).

40. Section 15(d) of the Exchange Act, until recently only required annual and periodic reports of companies which had registered, under the Securities Act of 1933, securities of a class aggregating more than two million dollars, however, under the 1964 amendments, reports are required of any company that offers its securities under a registration statement so long as it has 300 holders of the class of security offered. Exchange Act 15 U.S.C. § 78(o)(d) (1964).

customers, or selling incentives exceeding the commissions paid in ordinary trading transactions, are required.[41]

The central policy embodied in the proposed rules is that exemptions from 1933 Act registration should be interpreted, not only in light of the character and extent of the disclosures already made by the issuer of securities, but also in light of the selling effort which can reasonably be anticipated.

IV. Scope of the Rules

As mentioned earlier, under the proposed rules answers to the questions of how long the purchaser in a private placement must hold and in what manner he may sell are dependent on whether he purchased securities in a *reporting* or *nonreporting* company. The answers are also dependent on whether he is a *control*[42] or *noncontrol* person.

From these variables the possible questions are as follows:

1. When may a control person sell investment stock in a reporting company?
2. When may a noncontrol person sell investment stock in a reporting company?
3. When may a control person sell investment stock in a nonreporting company?
4. When may a noncontrol person sell stock in a non-reporting company?

At first blush the answers appear simple. The control person in a reporting company may sell specifically limited quantities in ordinary brokerage transactions at the end of one year[43] and the noncontrol person in the reporting company is afforded the same treatment.[44] The control person in a nonreporting company may never sell,[45] while the noncontrol person in a reporting company may sell all of his securities at the end of five years.[46]

In order to analyze these answers, three key definitions in the proposed rules must be considered. They are:

(1) rule 162 which defines the term "distribution;"
(2) rule 161 which defines the term "restricted security;" and
(3) rule 163 which defines the term "underwriter."

41. Wheat Report, at 187.

42. The Wheat Report did not clarify the conditions under which a person would or would not be deemed to be in control. On the problem of control, *see* Enstam and Kamen, *Control and the Institutional Investor*, 23 Bus. Law 289 (1968); Sommer, *Who's "In Control"—SEC.*, 21 Bus. Law 559 (1966).

43. Proposed rule 162(a) 3, 4, 34 Fed. Reg. 14229 (1969).

44. *Id.*

45. *See* Wheat Report, at 25.

46. Proposed rule 161 (b), 34 Fed. Reg. 14230 (1969).

V. DEFINITIONS

A. *Distribution*

Paragraph (b) of proposed rule 162 defines distribution as any public offering of a security unless specified requirements are met. In substance, these requirements provide that restricted securities of a reporting company which have been held for one year, may be sold without registration, in specified limited quantities in ordinary brokerage transactions.

The definition of "distribution" is consistent with the theory that if there has been no disclosure of a company's financial condition then a sale to the public of that company's securities ought to be registered while a company which has already registered a class of its securities and files up to date reports of its financial condition, ought to be able to sell securities to the public without registration. For example:

> (1) Nonpublic transactions are excluded from the term "distribution" and do not require registration of the securities involved; (2) any public offering of the securities of an issuer which is not subject to appropriate reporting requirements is a "distribution", and (3) a public offering of the securities of an issuer which is subject to the reporting requirements and is not delinquent in its filings is not a "distribution" . . . if the amounts involved and the method of sale are consistent with ordinary trading."[47]

Objective tests were needed to determine what sales were "consistent with ordinary trading" and therefore, for purposes of predictability and certainty, the Study, for the most part, adopted present day rule 154[48] to deal with the quantity limitations. That rule was designed to separate routine trading transactions from transactions involving the disposition of a large block of securities by means of extra-selling incentives. Basically, within the limits of rule 154, a broker may effect casual sales for a control person, through normal brokerage transactions, provided he is not an underwriter to the stock sold.[49] In computing the quantitative limits, the amount covered by the sell order is added to all other sales made by or attributed to[50] the control person within the preceding six months. If

47. Wheat Report, at 189, 190.

48. Rule 154(a), 17 C.F.R. § 230.154 (1970) [promulgated in SEC Securities Act Release No. 3421 (Aug. 2 1951) and renumbered 154(c) by SEC Securities Act Release No. 3525 (Dec. 22 1954)].

49. Rule 154 merely defines the brokers exemptions of §4(4) of the Exchange Act; the seller must find his own exemption. When the seller is not an underwriter and the proscribed selling effort is not present, his part in the transaction is exempt under § 4(1). In any event, the broker is under an obligation to inquire as to whether the seller is engaged in a distribution or is an underwriter.

50. Sales by persons affiliated with the control person or by their donees may have to be included in determining the availability of the rule. SEC Securities Act Release No. 4669 (Feb. 17, 1964).

this total does not exceed one percent of the issuer's outstanding stock, a sale of over-the-counter stock, will not be deemed a distribution. In the case of listed stock, if the total does not exceed the lesser of the one percent rule mentioned above or the largest weekly volume of trading within any one of the four calendar weeks preceding the receipt of the sell order by the broker, the sale is not deemed a distribution.

The basis of the limitations represent the Commission's estimate of what the market can absorb without resort to the proscribed selling effort since the essence of distribution is selling effort. If selling effort is present in a Rule 154 transaction, the broker loses his Section 4(4) exemption and comes within the terms of Section 2(11) as a seller for a control person. The basic quantity limitations of Rule 154 were retained with the following changes: (1) private placements of securities within the preceding six months do not reduce the quantity which may otherwise be sold; (2) only those members of a carefully defined family group are considered together as one "person" for purposes of the quantity limitation; (3) sales may be made in successive six-month periods; (4) inquiry by the broker of other bona fide broker dealers is not prohibited; (5) the broker involved is permitted to remain in the "sheets" if acting as a genuine market maker; and (6) commission limits are specified by reference to the minimum commission required by the exchange on which the security is listed and, for over-the-counter securities, by reference to the minimum New York Exchange commission schedule.[51]

The new definition gives equal treatment to securities sold on behalf of controlling persons and to securities acquired in private placements. In each case, the purchaser of the securities, after holding for one year, is permitted to resell in unsolicited transactions, limited amounts of a security purchased in a private placement, as discussed above. However, this provision is only available if the security is that of a reporting company; *i.e.*, a company, which because of compliance with Section 5 of the 1933 Act or with Sections 12(g) or 15(d) of the 1934 Act, has registered the security and is filing periodic annual reports with the Commission. Under proposed rule 164, the identity of such companies would be kept current through maintenance by the Commission of a "qualified list."[52] Because of the equal treatment afforded control and noncontrol persons, a present anomaly created by Commission Rule 154 will no longer exist. No longer will a controlling shareholder of a corporation be able to sell securities worth several million dollars which he acquired in the market without registration, whereas a supervisory employee who purchased and signed an "investment letter" for 100 shares a year ago in an unregistered employees' stock purchase plan, would be advised he could not sell his shares through his broker.

51. Wheat Report, at 21.

52. Proposed rule 164, 34 Fed. Reg. 14231 (1969).

B. *Restricted Security*

A restricted security is defined in proposed rule 161 to mean "any security acquired directly or indirectly from its issuer, or an affiliate of its issuer in a transaction or chain of transactions none of which was a public offering or other public disposition."[53] In short, any person who disposes of a "restricted security" in a distribution would be an "underwriter" and underwriter transactions are not exempt from registration under the 1933 Act.

An important question considered by the Study Group was whether the prohibition on the sale of securities by private purchasers should continue indefinitely, subject only to further private placements, to resales under Regulation A,[54] and in the case of reporting companies, to the limitations of proposed Rule 162 (already discussed). At least one commentator has indicated that the prohibition on public resale of any securities originally taken in a private placement should continue indefinitely.[55]

The Study Group, however, viewing perpetual restraints on alienation with disfavor, determined the restrictions should last for a definite period of years after which the securities would be free of restrictions on resales. The Study Group suggested a five year period. However, in order to prevent circumvention of the rules through the employment of shell corporations, and to insure that the issuer has an active business, one qualification was placed on the five-year rule. The proposed rule requires that the issuer have annual gross revenues of at least $250,000 from the conduct in the ordinary course of its business during four of the five years since issuance or purchase from a control person.[56]

The five year requirement, as well as the gross revenue test, merit further comment. To begin with, the selection of the five year requirement was completely arbitrary. Furthermore, when evaluated in connection with the new provision that any non-private sale of securities of a non-reporting company will constitute a distribution, the five year requirement appears to be unreasonably long. It also appears unreasonably long in light of the fact that, although there is no set holding period, securities attorneys felt relatively sure that immunity came to a private purchaser after a lapse of possibly two years and that such a holding period could be shortened by a change in the investor's circumstances. It is not surprising, therefore, that one commentator has already recommended that the "restricted period" be limited to three years.[57] It should be noted, however, that the proposed rules take effect prospec-

53. Proposed rule 161(a), 34 Fed. Reg. 14229 (1969).

54. Securities are "qualified" for sale to the public by compliance with provisions of SEC Reg. A, 17 C.F.R. §§ 230, 251-63 (1964).

55. Cohen, *Truth in Securities Revisted*, 79 HARV. L. REV. 1340, 1404 (1966).

56. Proposed rule 161 (c), 34 Fed. Reg. 14229 (1969).

57. *See* Throop, *Federal Regulation of Securities Committee Comments on the Wheat Report*, 25 BUS. LAW. 39, 46 (1969).

tively[58] and therefore the holder of securities acquired in a private placement prior to the effective date of the new rules, may resell without registration at whatever time and under whatever circumstances resales would previously have been permitted. Also, in the interest of a consistent policy for the protection of public investors in all secondary securities transactions, the revised rule would not permit sale without registration of control stock of a nonreporting company.

As was mentioned earlier, the restricted security becomes unrestricted after five years from issuance or purchase from a controlling person, only if the issuer meets the gross revenue test. The other qualifications in the proposed rules have as their basis, logically enough, the status of the issuer as a reporting or non-reporting company as well as "... the need of the offerees for the protection afforded by registration."[59] The gross revenue test, however, bears no relationship to the above criteria and directs itself solely to the size of the issuer's operations. In this way, the test could operate to prohibit the resale of securities without registration, even though a company operates in good faith and even though the company appears on the rule 164 Qualified List. Also, the test could, in certain situations, be unduly harsh on the noncontrol person. A situation could occur, for example, in which a nonreporting company fails to have a gross revenue of $250,000 in one of the last four years. In this event, the noncontrol person is not free to sell until there are at least four consecutive $250,000 gross revenue years. However, the same shareholder (noncontrol) in a reporting company, even if the company is losing money, is free to sell within the confines of the quantity limitations in proposed rule 162.

Finally, the gross revenue test appears to take on the characteristic of "Blue Sky" legislation since it tends to control the quality of securities being offered to the public,[60] instead of confining itself to the purpose of adequate disclosure laid down by the Securities Act of 1933.

C. *Underwriter*

Proposed Rule 160 defines an underwriter as a person who participates or is connected with a "distribution" of "restricted" securities. Once again, subjectivity is replaced by an objective test, since the components, "distribution" and "restricted securities", have been defined by other rules.

At the present time the law dealing with statutory underwriters depends in large part on investment intent. Briefly stated the law and the problem presented are as follows. Section 5, the heart of the Securities Act of 1933, makes it unlawful for any person to use the mails or any means of interstate commerce to sell a security for which a registration is not

58. Wheat Report, at 217.

59. S.E.C. v. Ralston Purina Co., 346 U.S. 119, 127 (1952).

60. On the subject of "Blue Sky" legislation, *see* SOWARDS, COMMENTS, CASES AND MATERIALS ON SECURITIES REGULATION 3, 12 (1966).

in effect.[61] Section 4(1), however, exempts from Section 5, "transactions by any person other than an issuer, underwriter or dealer."[62] Assuming for purposes of this analysis that the control persons are not issuers or dealers, the only question raised deals with the underwriter category. Section 11 provides the statutory answer.

> [T]he term "underwriter" means any person who *has purchased from an issuer with a view to,* or offers, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, ...[63]

The definition of underwriter includes not only the professional underwriter who may be thought of as part of the machinery of public distribution, but also includes any person who takes from a controlling stockholder with "a view to distribution." Whether the purchaser took the securities "with a view" to their subsequent "distribution" is determined by his intent at the time of purchase.

In order to eliminate the subjective factor of intent the proposed rule removes the emphasis given to the phrase "has purchased from an issuer with a view to . . . ." in section 2(11) in the 1933 Act and instead, the proposed rule incorporates the following precise definition:

> *or* offers or sells for an issuer in connection with, the distribution of any security, *or* participates or has a direct or indirect participation in any such undertaking, *or* participates or has a participation in the direct or indirect underwriting of any such undertaking; . . . .[64]

No longer will it be necessary to prove that a person lacked investment intent in order to find that he is an underwriter of securities if it can be shown that he has disposed of restricted securities in a distribution. A person holding securities originally sold by the issuer or by a controlling person in a nonpublic offering need only show that his sales, whenever occurring, did not amount to "distributions," and that the securities he sold, at the time of sale, were no longer restricted.

VI. Conclusion

Because of the proposals in the Wheat Report, the question "How long must I hold?" may finally be answered. The effect of the possible answer is two-fold. First, investors who purchase securities in a private

61. 15 U.S.C. § 77(e) (1964). The Securities Act requires that each distribution be registered; consequently the mere fact that the security has already been registered by the issuer will not release the nonissuer of his duty to register. *See* I L. Loss, Securities Regulations 297 & n.98 (2d ed. 1961).

62. 78 Stat. 65 (1964), *amending* 15 U.S.C. § 77(d) 1 (1958).

63. 15 U.S.C. § 77(6) 11 (1958) (emphasis added).

64. Wheat Report, at 203 (emphasis added).

placement would be assured that they would not be locked in for an indefinite period of time. Second, organizers of a venture whose needs dictate the private placement methods of financing could approach prospective investors armed with an unequivocal answer to the much asked question.

In their attempt to see the "whole of disclosure" through examination of its parts, the Study Group weighed fairly the many interests involved. The solutions proposed are well-reasoned and will make a tremendous contribution to the area of securities regulation.