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# The Ramifications of Sec Rule 154

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# THE RAMIFICATIONS OF SEC RULE 154

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## I. INTRODUCTION

Rule 154, promulgated by the Securities and Exchange Commission,<sup>1</sup> has caused much excitement in the financial community of late. As recently as 1966, the Securities and Exchange Commission issued a release so as to alert the public to the inherent limitations of its Rule 154.<sup>2</sup> Also, the recent case of *United States v. Wolfson*<sup>3</sup> for the first time employed Rule 154 as the indirect means of imposing criminal sanctions upon a "control person" for selling unregistered securities.

The purpose of this comment is to develop and explain the reasons, complexities and ramifications of Rule 154.

## II. BACKGROUND

### A. *Related Statute: Section 5*

To comprehend the complexities of Rule 154, one must first understand the reason for its creation. This can best be understood by examining related statutes.

Section 5 of the Securities Act of 1933<sup>4</sup> prohibits offers both to sell and to buy a security before a registration statement is filed with the SEC if the facilities of interstate commerce or the mails are used. Section

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1. 17 C.F.R. § 230.154 (Rev. 1968).

2. SEC Securities Act Release No. 4818 (Jan. 21, 1966).

3. *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968).

4. 15 U.S.C. § 77e (1964).

5 is the means of fulfilling the legislative objective of the 1933 Act. The investing public was intended to have available to it adequate information upon which it could make an informed judgment with respect to the purchase of securities.

The prohibition against the interstate sales of unregistered securities must be read in conjunction with the exemptions from registration as permitted by the 1933 Act. Thus, stated in elementary terms, a security must be registered before being offered for interstate sale unless an exemption under or pursuant to an act of Congress is applicable.<sup>5</sup>

#### B. *Related Statute: Section 4(1)*

Section 4(1) of the 1933 Act<sup>6</sup> exempts from the registration requirements of section 5 transactions by persons other than issuers, underwriters or dealers. The purpose of this exemption is obviously to exempt from registration the transaction of ordinary investors.

It is therefore important to ascertain the definition of an issuer, an underwriter, and a dealer. Section 2(12),<sup>7</sup> in defining a dealer, states that any person who engages either for all or part of his time, directly or indirectly, as agent, broker of principal in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another is a dealer.

Section 2(4)<sup>8</sup> defines an issuer as one who issues or proposes to issue a security.

Section 2(11)<sup>9</sup> defines an underwriter as "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. . . ."<sup>10</sup> The last sentence of 2(11) states that the word "issuer" includes in addition to an issuer any person directly or indirectly controlling or controlled by the issuer or any person under direct or indirect common control with the issuer.

Thus, the definition of underwriter in section 2(11) is said by many to be the most significant definition in the Securities Act of 1933. Because of its far-reaching effect, one may be a "statutory underwriter" within section 2(11) even though he has no connection with the securities business. Further, a control person may be a "statutory issuer" for the purpose of making another a "statutory underwriter."

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5. Various sections of the Securities Act of 1933 and the Securities and Exchange Act of 1934 impose civil and criminal penalties for violation of § 5.

6. 15 U.S.C. § 77(d)(1) (1964).

7. *Id.* § 77(b)(12).

8. *Id.* § 77(b)(4).

9. *Id.* § 77(b)(11).

10. However, the statute goes on to state that such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributor's or seller's commission. *Id.*

The ramifications of section 2(11) can best be shown by the use of examples:

*Example 1*—Suppose *ABC, Inc.* sells securities to *X*, a non-control person. *X* purchases the securities with the view to distribute them for the issuer. *X* would be a "statutory underwriter" within the meaning of section 2(11) and would not be entitled to the exemption from registration permitted to persons other than issuers, underwriters or dealers. It should be noted that if instead of purchasing the securities from *ABC, Inc.* and subsequently reselling them, *X* merely distributed the securities for *ABC, Inc.*, the same result would follow.

*Example 2*—Suppose *X*, a "control person" in *ABC, Inc.*, is the current owner of 1000 shares of *ABC* securities. If *X* sells the securities to *Y*, and *Y* purchases the securities with the view to distribute them for *X*, *Y* would be a statutory underwriter. Because of the last sentence of section 2(11), *X* would be considered an issuer for the purpose of making *Y* a statutory underwriter.

### C. The Concept of Control

The words "control person" have been used above without being defined. Their meaning is of extreme importance, because a person who is in control of an issuer is in virtually the same position as the issuer itself insofar as registration of the securities is required.<sup>11</sup>

The control status is not determined by any one fact. Rule 405 of the Securities Act<sup>12</sup> defines control as the possession, direct or indirect, of the power to cause the direction of the management and policies of a person. This definition is obviously vague and highly dependent upon the facts of each case.<sup>13</sup>

Although the control concept under the 1933 Act is not defined by statute, it was expressly passed upon in *United States v. Re*,<sup>14</sup> wherein it was held that control is no different under the Act from what it is in normal every day usage. The court said that the requirement of reasonable certainty does not preclude the use of ordinary terms to express ideas which find adequate interpretation in common usage and understanding.<sup>15</sup>

Everyone would agree that ownership of 51% of the voting power of a corporation is undoubtedly control.<sup>16</sup> However, a lesser amount of voting power could constitute control. In fact, many believe that ownership of 10% of the voting securities of a corporation raises a rebuttable presumption of control.<sup>17</sup>

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11. H. SOWARDS, COMMENTS, CASES AND MATERIALS ON SECURITIES REGULATION 159 (1966).

12. 17 C.F.R. § 230.405 (Rev. 1968). See also SEC v. Micro-Moisture Controls, Inc. 148 F. Supp. 558, 562 (S.D.N.Y. 1957).

13. See Thompson Ross Securities Co., 6 S.E.C. 1111 (1940).

14. 336 F.2d 306, 316 (2d Cir. 1964), cert. denied, 379 U.S. 904 (1964).

15. *Id.*

16. See Thompson Ross Securities Co., 6 S.E.C. 1111 (1940).

17. This is probably due to the fact that Rule 16, promulgated under the Securities

The fact that one is an officer or director of a corporation, although indicative of control, is not determinative of the question. It is possible that such officer or director has consistently and vehemently opposed the actions of the majority. If this is the case, the control status on the part of the officer or director would be negated. Conversely, the following factors would strongly indicate the control status of an officer or director:<sup>18</sup>

- (1) participation in active management;
- (2) necessity of his stock to establish a quorum at the annual shareholders meeting;
- (3) consistency in going along with the actions of others in management; and
- (4) his ownership of perhaps 5% or more of the outstanding voting securities.

D. *Related Statute: Section 4(4)*

Section 4(4), formerly 4(2) of the Securities Act of 1933,<sup>19</sup> is commonly referred to as the broker's exemption. However, not all broker's transactions are exempt.

Until 1946, the Commission took the position that if a broker effected an isolated transaction for a control person, the broker was entitled to the broker's exemption.<sup>20</sup> In other words, the Commission felt that the broker was not an underwriter even though he technically was selling for an issuer within the contemplation of section 2(11).

The caveat of the time was that a broker effecting a *distribution* of a substantial amount of securities would of necessity perform duties which were considered abnormal to the function of a broker.<sup>21</sup> If such were the case, it was unequivocally felt that such a broker, who had exceeded his ordinary brokerage functions in relation to a transaction, would be deemed an underwriter. Hence, the broker could not escape registration via the predecessor of 4(4).

During the "bull" market of 1945 and 1946, it became obvious that large amounts of securities could be sold without any abnormal brokerage functions. It was in the midst of this realization that the Commission decided the *Ira Haupt*<sup>22</sup> case. In an administrative proceeding against the Haupt firm it was learned that 93,000 shares, constituting nearly 36% of the outstanding stock of a corporation, were sold through Haupt by controlling shareholders. The Commission stated that section 4(2), now

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and Exchange Act of 1934, and form S-1, the most often used application for registration, differentiate between 10% owners of securities and less-than-10% owners.

18. See H. SOWARDS, 11 THE FEDERAL SECURITIES ACT § 4.04[2] (1968).

19. 15 U.S.C. § 77(d)(4) (1964).

20. L. LOSS, 1 SECURITIES REGULATION 700 (2d ed. 1961).

21. *Id.* at 701.

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

4(4), exempts trading but not a distribution by a broker for a control person.<sup>23</sup> Consequently, the exemption was not permitted.

In accordance with the *Haupt* case a new caveat came into being, *i.e.*, a broker effecting a *distribution* for a control person acts as an underwriter and thus is not entitled to the broker's exemption for his part of the transaction.

It soon became apparent that it was at times very difficult to distinguish between a non-exempt secondary distribution and the kind of brokerage transaction on behalf of a control person which was still exempt from the registration requirements of the 1933 Act.

Despite the confusion caused by the *Haupt* case, the predecessor of section 4(4) was not amended. This was because of the Commission's assurance of a future rule which would explain in more precise terms when a broker is to be considered a broker and when he is to be considered an underwriter.<sup>24</sup> After much deliberation, the Commission promulgated Rule 154.<sup>25</sup>

### III. RULE 154

#### A. *In General*

In accordance with Rule 154 the term "broker's transaction" in section 4(4) is defined to include a transaction by a broker acting as agent for a control person if four conditions are present. In brief, the broker can perform no more than the usual broker's function; the broker can receive no more than the usual brokerage commission; the broker cannot solicit the buy order; and the broker must not be aware of circumstances indicating that the transaction is part of a distribution or that the broker's principal is an underwriter.<sup>26</sup>

Securities Act Releases indicates that Rule 154 was not intended to provide an exemption from registration for the control person, but solely to exempt the selling broker's transaction.<sup>27</sup> The control person must still find his own exemption if the securities are not offered and sold in compliance with the registration requirements of the 1933 Act. However, as will be explained later, what Rule 154 does not do directly with respect to finding an exemption for the control person it does accomplish indirectly.

#### B. *Conditions of Exemption Explained*

Rule 154 explains that one condition which a broker must fulfill in order to qualify under the 4(4) exemption is that he perform no more

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23. *Id.* at 602.

24. L. LOSS, 1 SECURITIES REGULATION 704 (2d ed. 1961).

25. 17 C.F.R. § 230.154 (Rev. 1968).

26. SEC Securities Act Release No. 4818 (Jan. 21, 1966).

27. SEC Securities Act Release No. 4669 (Feb. 17, 1964); SEC Securities Act Release No. 4818 (Jan. 21, 1966).

than the usual and customary broker's function. In this respect the particular transaction in question is examined independently from the firm's general activities.<sup>28</sup>

The broker's functions in relation to the particular transaction must be distinguished from that of an underwriter or a dealer. This can be accomplished by receiving the normal brokerage commission for services performed in the capacity of an agent for his principal.<sup>29</sup>

Another condition of qualification states that the broker must do no more than execute an order to sell as a broker and receive no more than the customary broker's commission. Further, the broker's principal, to the knowledge of the broker, must make no payment in connection with the execution of such transaction to any person.<sup>30</sup>

Listed securities present no problem in ascertaining the customary broker's commission as a schedule exists for stock exchange transactions.<sup>31</sup> However, commissions with respect to unlisted securities often do raise problems.

In an effort to prevent the creation or stimulation of a market for the securities prior to registration, the broker will lose his section 4(4) exemption if he has knowledge that his principal has paid another person in connection with the transaction.<sup>32</sup>

A further condition states that neither the broker nor, to his knowledge, his principal solicits or arranges for the solicitation of orders "to buy" in anticipation of or in connection with such transactions. This condition of the broker's eligibility of the section 4(4) exemption prohibits only the solicitation of "buy orders" from the broker's customers. The broker is free to solicit the "sell order" from the control person.<sup>33</sup> This is apparently because of the fact that the rule is primarily designed for the protection of buyers, not sellers.

The last condition states that the broker must not be aware of circumstances indicating that his principal is an underwriter in respect to the securities or that the transactions are part of a distribution on behalf of his principal. In other words, if the control person (the principal in the transaction) purchased the securities with a view to resell, or was otherwise an underwriter within the definition of section 2(11), the control person's broker could not take advantage of Rule 154.

It should be noted that "the broker must make a reasonable investigation with respect to the controlling person's status as an underwriter and with respect to whether the proposed transaction will constitute a distribution."<sup>34</sup>

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28. *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269 (10th Cir. 1957).

29. H. SOWARDS, 11 *THE FEDERAL SECURITIES ACT* § 4.04[3](c) (1968).

30. 17 C.F.R. § 230.154 (Rev. 1968).

31. H. SOWARDS, 11 *THE FEDERAL SECURITIES ACT* § 4.04[3], n.63 (1968).

32. *Id.* at § 4.04[3](e).

33. SEC Securities Act Release No. 4818 (Jan. 21, 1966).

34. H. SOWARDS, 11 *THE FEDERAL SECURITIES ACT* § 4.04[3](e) (1968).

The Commission takes the view that "[t]he broker is at least obligated to question his

### C. *Rule of Thumb: Guidelines*

In order for the broker to be exempt from registration his "control" seller must not be involved in a *distribution*. Paragraph B of Rule 154 explains what a distribution is by stating what it is not: No distribution will be involved if the transactions do not involve a substantial amount in relation to the number of shares or units of the outstanding securities and the aggregate volume of trading in such security. This raises the all important question: what is substantial?

Rule 154 provides the following rule of thumb for distinguishing trading from distribution in routine cases: It is not a distribution if all sales made by or on behalf of the same person within six months do not exceed the lesser of one percent of the outstanding shares or, where the security is listed, one week's volume of trading within the preceeding four calendar weeks.<sup>35</sup>

A word of caution is in order. The 1% rule is only a guideline which must be read in conjunction with Rule 154's position that if a substantial amount of securities are traded in relation to the aggregate amount of trading the exemption will be lost. Thus, when dealing with an irregularly traded unlisted security even though the 1% rule is met, the exemption may be disallowed. The converse of this is also true. As stated by Mr. Shreve, the Executive Assistant Director of the Division of Corporate Finance, "I recall one case where the volume of trading over the counter was substantially greater than the volume of trading on the exchange—the real market was over the counter—we were able to arrive at some conclusion that a somewhat greater amount of stock could be sold than the exchange would permit under the rule of thumb."<sup>36</sup>

## IV. PRACTICAL PROBLEMS OF BROKER IN COMPLYING WITH RULE 154

### A. *Who Is a "Person" for Calculating Sales within the Previous Six Months?*

Rule 154(b) requires the inclusion of all sales by the same person or his associates within the preceeding six months in order to determine the amount of securities remaining to be traded under the six-months/1% guideline of Rule 154.<sup>37</sup> Further, if the control person's sales within the previous six-month period are but a part of a concert of action being effected by a group of closely related persons of which the control person is a member, the offering of the group as a whole would have to included

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customer to obtain facts reasonably sufficient under the particular circumstances to indicate whether his customer is engaged in a distribution or is an underwriter." SEC Securities Act Release No. 4818 (Jan. 21, 1966).

35. 17 C.F.R. § 230.154 (Rev. 1968).

36. Shreve, *Unsolicited Brokers' Transactions and Investment Stock*, in *SECURITIES LAWS AND REGULATIONS INSTITUTE* 91, 100 (H. Sowards ed. 1967).

37. SEC Securities Act Release No. 4818 (Jan. 21, 1966).

as a single computation under Rule 154(b). If the specified amount was exceeded, the exemption is unavailable.<sup>38</sup> This is because Rule 154 was not intended to provide an exemption for portions of group distributions.

In making this calculation all transactions including previously exempt ones within the previous six-month period must be included.<sup>39</sup> Thus the broker of a control person, in a corporation with 1,000,000 shares outstanding, who has within the previous six months sold 10,000 shares or more through another exemption permitted by the Securities Act of 1933, cannot effectuate the transfer of additional shares for the control person.

B. *Must the Broker of a Control Person's Donee Comply with Rule 154?*

"If a distribution is a reasonable consequence of a gift by a control person, registration may be required,"<sup>40</sup> but Rule 154 and section 4(4) have been used in such situations without objection on the part of the Commission.<sup>41</sup> However, it is necessary to calculate the exemption available to the control person at the time of the sale.<sup>42</sup> The combined sales of the donor, his associates and the donee should not exceed the limitations set forth in Rule 154(b). Conversely, the number of shares given to a donee and then sold should be taken into account in determining whether the control person is within the limits of routine trading insofar as a broker selling for the control person is concerned.<sup>43</sup>

C. *Must the Broker of a Control Person's Pledgee Comply with Rule 154?*

In accordance with the *Guild Films*<sup>44</sup> case, when a lender accepts securities from a control person as collateral for a loan, absent an exemption, the lender must comply with the registration and the prospectus requirements of the Securities Act before he can sell the securities. However, since the pledgee, in effect, stands in the shoes of and acts for the pledgor in selling the collateral (securities), the SEC takes the position that the broker may sell for both the lender and the borrower if the total dispositions are within the limitation of Rule 154(b).<sup>45</sup>

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38. *Id.*

39. *Id.*

40. Shreve, *Unsolicited Brokers' Transactions and Investment Stock*, in *SECURITIES LAWS AND REGULATIONS INSTITUTE* 91, 101 (H. Sowards ed. 1967).

41. *Id.*

42. *Id.*

43. SEC Securities Act Release No. 4818 (Jan. 21, 1966).

44. SEC v. *Guild Films Co.*, 279 F.2d 485 (2d Cir. 1960), *cert. denied* 364 U.S. 819 (1960).

45. SEC Securities Act Release No. 4669 (Feb. 17, 1964); SEC Securities Act Release No. 4818 (Jan. 21, 1966).

D. *What is the Effect of Compliance with Rule 154(b) in Consecutive Six-Month Periods?*

The SEC takes the position that a plan to effect a series of sales every six months must result in a distribution beyond the limitations of the Rule.<sup>46</sup> Thus, repetitive compliance with the one percent guideline of Rule 154(b) cannot assure the section 4(4) exemption for the broker. This writer believes that this point is in dire need of clarity because of its vagueness. It is understood by this writer that *no one* knows how many successive six-month periods are within the routine trade requirement of Rule 154.

V. THE INDIRECT EFFECT OF RULE 154 ON THE CONTROL PERSON (UNITED STATES V. WOLFSON)

The correlative of the problems facing the broker for noncompliance with Rule 154 concerns itself with the control person.

The recent landmark case of *United States v. Wolfson*<sup>47</sup> was the first to impose criminal sanctions on a control person for selling unregistered stock. The facts indicate that between August, 1960, and January, 1962, 2,510,000 shares of Continental Enterprises, Inc., an unlisted corporation, were issued and outstanding. The Wolfson group, including Wolfson himself, his family and his right-hand man, owned in excess of 40% of of the outstanding shares. During the period in question the group sold in excess of 625,000 shares of Continental through various brokerage houses.

The court found that although Wolfson was neither a director nor an officer in Continental, "(a)s the largest individual shareholder he was Continental's guiding spirit. . . ."<sup>48</sup>*i.e.*, a control person. Thus, his sales of unregistered stock were in violation of section 5 of the Securities Act of 1933.

A defense raised by Wolfson on appeal was that his sales were exempt under section 4(1) of the 1933 Act either because he was not himself an issuer, underwriter or dealer, or alternatively because the brokerage houses through which his sales were accomplished were not underwriters.<sup>49</sup> It was argued that while a "controlling person" of an issuer may be deemed an issuer for purposes of the definition of an "underwriter," he is not an issuer for purposes of section 4(1).

In dismissing the above argument the Second Circuit stated that section 4(1) by its terms exempts only transactions, not persons. Since the brokers provided outlets for the stock of issuers within section 2(11), they were underwriters. Therefore, the stock was sold in *transactions by underwriters* which are not within the exemptions of 4(1).

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46. SEC Securities Act Release No. 4818 (Jan. 21, 1966).

47. *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968).

48. *Id.* at 97571.

49. Brief for Appellant at ii; *id.* at 97572.

In response to the argument that the brokers in the case could not be classified as underwriters because their part in the sales transactions came within section 4(4), the broker's exemption, the court said that section 4(4) was designed only to exempt the broker's part in security transactions. The court implied that although the 1% guideline of Rule 154 had been exceeded, the section 4(4) exemption could be applicable to the brokers if they were not aware of circumstances indicating that the transactions were part of a distribution of securities on behalf of their principal. The court did go on to state, however, that a distribution was effected since the sales were substantial in relation to the number of shares outstanding.<sup>50</sup>

Although the court emphasized that section 4(4) and its counterpart Rule 154 do not provide an exemption for the control person, it is contended that Rule 154 does so indirectly, *i.e.*, if a broker is not an underwriter within section 2(11) because his "control" principal was not involved in a distribution as defined in Rule 154, no transaction involving either an issuer or an underwriter would result. Thus, if Wolfson had complied with the definition of a routine trade within the limits of Rule 154, he would have been entitled to the section 4(1) exemption.

## VI. CONCLUSION

As discussed above, the ramifications of Rule 154 are far-reaching. The broker is directly affected by its limitations, *i.e.*, he can take advantage of the section 4(4) broker's exemption for his part of the transaction only if his "control" principal's activities with regard to the securities are deemed a routine trade and not a distribution within the meaning of Rule 154. The control person, on the other hand, apparently can employ the section 4(1) exemption unless his activities with regard to the securities are deemed a distribution within Rule 154.

In spite of the SEC's manifest concern with affording due process to potential violators of its securities laws, it is this writer's opinion that Rule 154 and security releases explaining the rule have fallen short with respect to the question of repetitive compliance with the rule in successive six-month periods. Securities Act Release No. 4818 states, in essence, that repetitive compliance in successive six-month periods with the 1% guideline may still result in a distribution, but no further guidelines are given. A bailout contrary to the intent of the Securities Act of 1933 and Rule 154 can certainly be effected by repetitive compliance with Rule 154. However, since the penalty for selling unregistered stock in the absence of an exemption could be incarceration, as in the *Wolfson* case, a high degree of clarity of notice should be afforded potential violators of the complex securities law.

Perhaps the means for presenting the public with a clear, precise rule,

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50. *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968).

and at the same time keeping with the intent and purpose of Rule 154, is the substitute rule now under consideration by the SEC:

Some consideration has . . . been given by the staff to modification of Rule 154 by the adoption of a substitute rule under 3(b) which would have a \$300,000 limit and require prior notice to the Commission. The rule might also be calculated on the basis of a twelve-month period rather than six-months so that we would not be as concerned with respect to repeat sales.<sup>51</sup>

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51. Shreve, *Unsolicited Brokers' Transactions and Investment Stock*, in *SECURITIES LAWS AND REGULATIONS INSTITUTE* 91, 103 (H. Sowards ed. 1967).