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Sales of Shares by Controlling Persons and Rule 154

Hugh L. Sowards

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I. INTRODUCTION

A substantial stockholder in a public company wishes to sell some of his shares on the open market. These shares have not been registered under the Securities Act of 1933.[1] Furthermore, the time, expense and other problems incident to registration make that route impractical. The question now arises concerning his legal right to sell these unregistered shares. May he sell any of them? If so, how many and how frequently?

These intensely practical questions have caused grave concern among securities attorneys and their businessmen clients. The reason for this concern stems mainly from an understandable inability to find the answers in the governing statutory provision, Section 4(2) of the Securities Act of 1933, as implemented by Rule 154.[2]

In the event of a public distribution of securities, the Securities Act of 1933 attempts to provide investor protection through full disclosure of all material facts. The required information is disclosed in a registration statement and prospectus filed with the Securities and Exchange Commission; the prospectus must be given to prospective investors. More

* Professor of Law, University of Miami. This article has been adapted from a chapter in a book on the Securities Act of 1933, to be published soon by Matthew Bender & Co., New York, N.Y. The author gratefully acknowledges the research assistance and suggestions of Mr. Arnold Schatzman in the preparation of this article.

1. 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77(a)-(aa) (1958). Throughout the remainder of this article the Securities Act of 1933 is referred to solely by section numbers.

2. 17 C.F.R. § 230.154 (1949). This rule, in effect, exempts brokers' transactions for a customer when the broker is acting as a broker rather than as an underwriter, and when certain other conditions are observed. For a full discussion of Rule 154, see text of this article following footnote 19.

particularly, Section 5 of the Act makes it unlawful to use "any means or instruments of transportation or communication in interstate commerce or of the mails" to sell securities unless a registration statement is in effect. This registration requirement applies both to the distribution of a new issue and to a redistribution of outstanding securities which "takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering."[3] In short, secondary *distributions* by controlling shareholders must be registered. However, Section 4 of the Act contains specific exemptions from the registration requirements. Moreover, Section 4(2) as implemented by Rule 154 and as currently interpreted may permit a controlling person to dispose of a portion of his securities on the open market within certain limitations. Section 4(2) exempts: "Brokers' transactions, executed upon customers' orders on any exchange or in the open or counter market, but not the solicitation of such orders."

II. Background of Section 4(2)

The purpose of this section was to exempt the ordinary brokerage transaction. Thus when John Jones sells 100 shares of ABC, Inc. through his broker, that brokerage transaction is exempted from the registration requirements of the Act. "To summarize: Section 4(2) permits individuals to sell their securities through a broker in an ordinary brokerage transaction . . . without regard to the registration and prospectus requirements of Section 5 . . . ."[4]

Thus far the language and purpose of the section appear plain and simple. But, as so often happens, through "interpretation" the section has become a veritable nightmare. For example, suppose that X, a controlling person, wishes to sell his securities through a broker. Assuming that X complies with the quantitative and other limitations of the section and its Rule 154, is it not reasonable to assume that such a *transaction* is entitled to the exemption? After all, the section does exempt "brokers' transactions." But the position was taken at an early date that the exemption applies only to the broker's part of the transaction and does not extend to the selling customer, who must find his own exemption.[5] Consequently, through "interpretation" what appeared to be a transaction exemption has become a "brokers' exemption," even though the broker is acting as the seller's agent. This type of reasoning is difficult to accept, but the interpretation is well entrenched and, until rejected by judicial decision, must be dealt with as it exists. In practical effect, the *ordinary seller* may rely on the first clause of Section 4(1) of the Act which exempts "transactions by any person other than an issuer, underwriter or

3. Ira Haupt & Co., 23 S.E.C. 589, 595 (1946). See also H. R. Rep. No. 85, 73d Cong., 1st Sess. 13-14 (1933).

4. Ira Haupt & Co., *supra* note 3, at 604.

5. SEC Securities Act Release No. 131, March 13, 1934.

dealer," for he falls within none of these categories.[6] But the problem is intensified when a person in a control relationship with the issuer wishes to sell securities through a broker. The point is that the exemption contained in the first clause of Section 4(1) may not be available for the reason that such a seller *is* an "issuer" or an "underwriter." This problem and related questions are discussed below.

III. THE CONCEPT OF CONTROL

Inasmuch as the exemption afforded by Section 4(2) and Rule 154 is of current significance with respect to transactions by controlling persons, the first question for consideration is: Who is a controlling person? The answer is not an easy one, for no single factor determines the control status. Rather, several factors may play a part in the determination of control in a particular case. Perhaps as good a *general* statement as any is contained in the following letter from the staff of the Commission, written in response to a company president's request for advice concerning past and proposed unregistered sales of stock:

> Dear Sir:
>
> Your letter of ———————— has been received and it is primarily the responsibility of the issuer, its officers and directors, its counsel and affiliated persons to determine which of the outstanding shares of ABC, Inc. may be resold without violating the registration requirements of the Securities Act. Generally speaking, however, any shares issued in the names of persons occupying a controlling relationship with the issuer of such securities or their nominees at the time of their transactions in the stock would be subject to this prohibition. Likewise, any such shares issued in the name of any person who would be considered an "underwriter," within the definition of that term in Section 2(11) of the Securities Act, would be subject to registration. An "underwriter," within the definition of this term, is a person who acquires stock from an issuer or its "controlling stockholder" for the purpose of resale or sells such stock for the account of these persons.
>
> The term "controlling stockholder," as I have used it in this letter, is *a question of fact dependent upon the circumstances of each transaction. It is not a narrow one, depending upon a mathematical formula of 51 per cent of voting power, but is generally considered to mean "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."* (See Rule 405 of the General Rules and Regulations under the Securities Act.)

6. Of course, even a non-controlling person *may* become a statutory underwriter, *e.g.*, where he has purchased his securities as part of a private placement and immediately resells without a bona fide change of circumstances. See Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959).

> While, as I have stated, the question presented is a factual issue, the stock issued to L. A. Jones, Mary C. Jones, individually and jointly, Roger Smith, John Thompson and M. O. Brown, or their nominees, would on the basis of the information thus far ascertained by us seemingly fall within the "control" category I have discussed. Also, stock transferred from any of these persons pursuant to an investment letter would also be subject to the same restrictions.
>
> If any of these persons were in no way connected with the management of the corporation, either directly or indirectly, at the time of their sale of the stock, such transactions may have been entitled to the exemption from registration provided in the first clause of Section 4(1) of the Act. However, this would only be true if they had held the stock long enough to establish an investment interest and it was fully paid for.
>
> Furthermore, as you know, any transactions in the stock, regardless of whether it may be exempt from registration, are subject to the prohibitions of Section 17(a) of the Act. Consequently, any sale of the stock by the issuer or by any person occupying a "controlling" relationship with the issuer, without a full disclosure of the present financial condition of the corporation and other comparable material information, would probably run afoul of this Section.
>
> Very truly yours,

The italicized portion of the foregoing letter was taken from Rule 405. That rule serves as a general guidepost. But, at least by implication, it involves numerous other factors which are discussed below.

A. *Stock Ownership*

While it is obvious that record or beneficial ownership of more than one-half of the voting securities constitutes control, it is equally apparent that one (or a group) owning less than that amount may occupy the status of a controlling person.[7] In this connection, Item 19 of Form S-1, the most generally used application form for registration, requires the registrant to list each person who owns "more than 10 per cent" of any class of voting securities. Awareness of this fact has caused most securities attorneys to conclude that the ownership of ten per cent or more of the voting securities in and of itself spells control. Furthermore, this "minority control" can exist in numerous forms, including: (1) pyramiding through holding companies; (2) issuance of a larger class of non-voting stock coupled with the issuance of a comparatively small amount

7. Thompson Ross Sec. Co., 6 S.E.C. 1111, 1119 (1940): "The question of 'control' is a factual question. 'Control' is not synonymous with the ownership of 51 percent of the voting stock of a corporation. Where power exists to direct the management and policies of a corporation, 'control' within the meaning of § 2(11) exists even though the persons who possess that power do not own a majority of the corporation's voting stock."

of voting stock; (3) the placement of comparatively few shares in the hands of one person or one group coupled with wide distribution of the remainder; (4) proxy control through committees; (5) control through voting trusts or protective committees in reorganization or bankruptcy proceedings.

Finally, in terms of stock ownership, it is clear that ownership of *less than* ten per cent does not spell absence of control. As indicated in the foregoing letter from the Commission, there is no "mathematical formula" for determining control. Other factors require consideration.

B. *Power To Direct Management and Policies*

A test frequently used in determining the existence of control concerns the ability of the person or group in question to direct management and policies of the issuer. As the court observed in the *Micro-Moisture* case,[8] "the defendants were in control because they possessed and exercised the power to direct the management and policies of Micro-Moisture (Rule 405) and *particularly were in a position to obtain the required signatures of Micro-Moisture and its officers and directors on a registration statement.*" (Italics added.) In this connection, it is important to note that the person or group in question need not exercise day-to-day managerial functions. The fact that the *power* to direct management and policy exists is sufficient for purposes of control.[9] This power may stem from one or more of several sources. Domination of officers and members of the board of directors or executive committee is a common example.[10] Similarly, such control might arise from interlocking corporate directorships or, as indicated in Rule 405, from contractual arrangements.[11]

C. *Officers and Directors as Controlling Persons*

The fact that a person is an officer or director does not in and of itself spell control. Indeed, the fact that an officer or director consistently

8. SEC v. Micro-Moisture Controls, Inc., 148 F. Supp. 558, 562 (S.D.N.Y. 1957), *final injunction*, 167 F. Supp. 716 (S.D.N.Y. 1958), *aff'd sub nom.*, SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959).

9. "It cannot be accepted that Walston believed that an employee driving an automobile controls that vehicle to the exclusion of his employer or that the officers of a corporation, in the exercise of their day-to-day and detailed managerial functions, control the corporation to the exclusion of a dominating financial interest." Walston & Co., 7 S.E.C. 937, 950 (1940). See also Thompson Ross Sec. Co., *supra* note 7, at 1121 (purchase from husband and wife with a view to distribution, where husband "could direct the policies of the issuer along whatever lines he deemed desirable," was a purchase from controlling person, making exemption under first clause of § 4(1) unavailable for subsequent sales to public).

10. Resources Corp. Int'l, 7 S.E.C. 689, 716-18 (1940).

11. Canusa Gold Mines, Ltd., 2 S.E.C. 548, 555 (1937) (underwriting agreement empowered underwriter to name a majority of the board of directors); Reiter-Foster Oil Corp., 6 S.E.C. 1028, 1044 (1940) (underwriter imposed condition precedent to underwriting that control of board be turned over to him).

opposed the policies of management or of those persons in mathematical control would tend to negate control on his part.[12] Similarly, a proxy contest or other evidence of dissatisfaction or conflict between the director or officer and management would indicate an absence of control on his part, especially if large blocks of stock held by other persons or groups have been used to outvote him. On the other hand, factors tending to indicate a control status would include: participation in active management by the officer or director or a member of his family; the necessity of his or his family's stock to establish a quorum at annual stockholders' meetings; his consistent acquiescence, in management policies; his ownership, record or beneficial, of perhaps five per cent or more of the outstanding voting securities. In the final analysis, of course, as stated previously, no single factor is determinative of a control relationship. At most, the foregoing factors should be considered in the light of the circumstances surrounding the particular situation.

A final word is in order on officers and directors. The fact that an officer or director has resigned and thus has no official connection with his company does not necessarily terminate what would otherwise be a control status. Through his stockholdings or through some other arrangements, formal or informal, he may be able to exert a very real influence on management policies.

IV. Sales by Controlling Persons

As stated previously, secondary *distributions* by controlling persons must be registered. Put another way, if a broker is selling for a controlling person in connection with a distribution, he is acting as an *underwriter* rather than as a broker. Consequently, the sales on behalf of the controlling person are not "brokers' transactions" and are not exempt under Section 4(2). Furthermore, if the securities are not registered, the broker will have violated Section 5, the section of the Act requiring registration, and the controlling person will have been exposed to liability as a principal under the federal statute prohibiting aiding and abetting.[13] It is obvious, then, that the words "underwriter" and "distribution" are of prime importance for the purpose of determining the availability of an exemption for sales by controlling persons.

Section 2(11) defines an "underwriter" as

12. In United States v. Sherwood, 175 F. Supp. 480, 483 (S.D.N.Y. 1959), although defendant was not a director, the court observed with respect to this point: "The evidence does not sustain the second charge that Sherwood was at the time of the sales a 'control person.' To the contrary, although Sherwood dominated 8% of the total issued stock, he was unable to secure a representation on the board of directors, he had had a falling-out with . . . the dominant figure in the management . . . ."

13. 18 U.S.C.A. § 2(b). Apparently the only case where it may make a difference whether the controlling person has violated § 5 himself or has aided and abetted in its violation is where unusual circumstances make it more advantageous to proceed against the controlling person alone without joining the broker-underwriter.

> any person who . . . sells for an issuer in connection with, the distribution of any security . . . . [A]s used in this paragraph the term "issuer" shall include . . . any person . . . controlling . . . the issuer . . . .

It is at once apparent that the last sentence of the foregoing section defines a controlling person as an "issuer" for the purpose of determining whether the person who sells for him is an "underwriter."[14] Moreover, the purpose of that last sentence is to require registration of secondary distributions through underwriters by controlling stockholders.[15] In sum, one may be a *statutory* underwriter even though he has no connection with the securities business. A common example occurs when one makes a secondary distribution of securities for the account of a person who is in a control relationship with the issuer of the securities. Accordingly, when Section 2(11) is read in conjunction with the first clause of Section 4(1) ("Transactions by any person other than an issuer, underwriter or dealer") and Section 4(2), the following principles emerge:

1. If X is in control of ABC, Inc., he is an "issuer" for the purpose of making an underwriter any person who purchases from him or sells for him in connection with a distribution of his securities.

2. If X, the controlling person, purchases his securities with a view to distribution, he himself is an "underwriter," making the exemption contained in the first clause unavailable to him.[16]

It should be stressed, however, that in the foregoing examples or in similar situations involving controlling persons, the Section 4(1) exemption is unavailable to the seller and the Section 4(2) exemption is unavailable to the broker *only if the "underwriter" takes from the "issuer" with a view to distribution.* To put it another way, all underwriting involves distribution. If the transaction in question does not involve "distribution," there is no underwriting. Thus if B, a broker, sells securities for X, the controlling person, and the transaction does not

14. Although an argument can be made to the contrary, it is the generally accepted view and the informal position of the Commission's staff that the purpose of the term "issuer" as used in the last sentence of § 2(11) is limited to determining whether one who purchases from a controlling person is an "underwriter." According to this view, a person who purchases from one in control of the issuing corporation in connection with a distribution is an underwriter, but the person in control of the corporation is not an issuer for the purpose of an exemption under §§ 3 and 4 of the Act or for the purpose of signing a registration statement.

15. "It is clear from Section 4(1), read in conjunction with Section 2(11), that public distributions by controlling persons, through underwriters, are intended generally to be subject to the registration and prospectus requirements of the Act." Ira Haupt & Co., *supra* note 3, at 601.

16. "Section 4(1) exempts trading transactions between individual investors with respect to securities already issued. It does not exempt distributions by issuers or control persons or acts of other individuals who engage in steps necessary to such distributions." SEC Securities Act Release No. 4445, Feb. 2, 1962. Similarly, the exemption under the first clause of § 4(1) is not available to a *dealer* making a distribution of its securities. Stadia Oil & Uranium Co. v. Wheelis, 251 F.2d 269 (10th Cir. 1957).

involve a "distribution," B is acting as a broker rather than as an underwriter, thus making the Section 4(2) exemption available to him and the Section 4(1) exemption available to X, assuming that X is also not engaged in a distribution. The next logical question, then, concerns the meaning of "distribution."

Prior to the *Haupt* case[17] the position of the Commission was to the effect that even "an *underwriter* selling for a controlling stockholder over the exchange might conceivably be entitled to the exemption under Section 4(2) if his activities were confined strictly to the usual brokerage functions, but that, as a practical matter, his activities could not be so confined in connection with a distribution of any *substantial block of securities*."[18] (Italics added.) The Commission went on to state, however, that such an interpretation was given before it realized that "large blocks can frequently be sold without solicitations or other sales activity." (Approximately 93,000 unregistered shares had been distributed in such a manner by Ira Haupt & Co. for the Schulte interests, controlling shareholders in Park & Tilford.) Accordingly, against the background of a "very different market," the pre-1946 interpretation, to some extent at least, was "overruled." The actual holding in *Haupt* was to the effect that a broker making a distribution for a controlling shareholder acts as an underwriter and cannot avail himself of the exemption in Section 4(2) for brokers' transactions. The opinion took the position that Section 4(2) was intended to distinguish between "trading" (exempt) and "distribution" (non-exempt) transactions. Much was made of this distinction, but the opinion caused confusion among brokers because of the absence of any concrete definitions of "trading" and "distribution." In short, the *Haupt* case left open the questions of when a broker was acting as a broker and when he was acting as an underwriter? It was for this reason that Rule 154 was adopted. That rule was an attempt to furnish standards for determining whether a particular transaction is that of a broker or an underwriter, *i.e.*, whether the transaction involves trading or distribution.[19]

V. Rule 154: General Observations

Rule 154 permits casual trading by controlling persons by defining "brokers' transactions" to include transactions which might otherwise be considered as transactions by an underwriter requiring registration.

17. Ira Haupt & Co., *supra* note 3.

18. *Id.* at 605.

19. "To obviate certain misapprehensions which had arisen following the Commission's decision in *Ira Haupt & Co.*, Rule 154 was adopted in 1954 as an interpretation of the statute in cases in which the broker is acting for a control person, 'to provide,' as the Commission stated at the time, 'a ready guide for routine cases involving trading, as distinguished from distributing transactions . . . .'" Remarks of Harold Lese, Chief Counsel, SEC Div. of Corp. Fin., Fed. Bar Ass'n Briefing Session, Wash., D.C., June 1, 1961.

But, in line with its position on Section 4(2), the Commission does not consider Rule 154 to furnish an exemption for the *seller*:

> Rule 154 . . . is too often referred to as the selling control person exemption. It must be appreciated that Rule 154 was in no way intended, nor does it by interpretation provide an exemption to control persons. Rule 154 is the selling broker's exemption. The selling control person must find his own exemption for the sale of his stocks. Generally, it is found in the first clause of Section 4(1) of the Securities Act for "transactions by any person other than an issuer, underwriter, or dealer."[20]

As noted previously in connection with the discussion of Section 4(2), this reasoning is difficult to follow in view of the fact that the section and the rule exempt "transactions." In any event, the selling control person is *indirectly protected* by Rule 154 in the sense that, if he is not making a distribution, the resulting availability of the exemption to the broker spells availability to the seller's own exemption for *his* part of the transaction under the first clause of Section 4(1).

A final general observation: it should be noted that the exemption under Section 4(2) and Rule 154 is confined to transactions "on any exchange or in the open or counter market." It is obvious, then, that the exemption is limited to transactions in the course of trading in *outstanding* securities. Accordingly, purchases made directly from an issuer during a primary distribution are not considered as transactions "in the open or counter market."

VI. LIMITATIONS ON APPLICABILITY OF RULE 154

Rule 154 defines "brokers' transactions" to include transactions by a broker acting for controlling persons where—

(1) the broker performs no more than the usual and customary broker's function,
(2) the broker does no more than execute an order or orders to sell as a broker and receives no more than the usual or customary broker's commission, and the broker's principal, to the knowledge of the broker, makes no payment in connection with the execution of such transactions to any other person,
(3) 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, and
(4) the broker is not aware of circumstances indicating that his principal is an underwriter in respect of the securities or that the transactions are part of a distribution of securities on behalf of his principal.[21]

20. *Ibid.*
21. 17 C.F.R. § 230.154(a) (1949).

A. *"Usual and Customary Broker's Function"*

In order to qualify for the Section 4(2) exemption, the first condition provides that the broker perform no more than the usual broker's function. In other words, he must act as a broker rather than as a dealer or underwriter. In this connection, a dealer acts as a *principal* rather than as an agent. Typically, a dealer buys for his own account and sells to a customer from his own inventory. The dealer's profit or loss is the difference between the price he pays and the price he receives for the same security.[22] But a broker acts as an *agent* who buys and sells for the account of others and charges a commission for his services. In short, satisfaction of this first condition requires that the broker act for his principal as an agent, receive commissions and take no profit and loss risks.[23]

B. *Broker Must Receive Usual Commission: Seller Must Not Pay Any Other Person*

In the case of stock exchange transactions there is a fixed schedule of commissions. Thus, no problem is presented with respect to what constitutes "the usual or customary broker's commission."[24] But there are no set commissions with respect to unlisted securities.[25] The suggestion has been advanced that, in order to insure satisfaction of this condition, the broker's commission should not exceed the equivalent of what would be a stock exchange commission on the same transaction—with the added proviso that the broker can safely charge a higher commission if he can establish that it would be usual and customary in similar transactions in unlisted securities.[26] Finally, the broker must not be aware that the seller has made any payments to other persons in connection with the transaction. In all likelihood, knowledge on the part of the broker of indirect payments to public relations firms or others in a position to create or stimulate a market for the securities would spell loss of the exemption.

C. *Solicitation*

As a third condition, Rule 154 expressly provides that there must be no solicitation of *buy* orders. In other words, if the broker solicits the

22. Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir.), *cert. denied*, 321 U.S. 786 (1943). See also Arleen W. Hughes, SEC Securities Exchange Act Release No. 4048 (Feb. 20, 1948), *aff'd*, 174 F.2d 969 (D.C. Cir. 1949).

23. Stadia Oil & Uranium Co. v. Wheelis, *supra* note 16, at 275 (holding that the availability of the § 4(2) exemption does not depend upon a firm's general activity as a broker but upon the capacity in which it executed the particular transaction).

24. New York Stock Exchange Commissions, for example, currently average approximately 1% of the market value of the shares involved in the transaction and approximately ¼ of 1% on bonds.

25. See National Ass'n of Securities Dealers, Inc., SEC Securities Exchange Act Release No. 3623 (1944).

26. See *Symposium—Current Problems of Securities Underwriters and Dealers*, 18 Bus. Law. 27, 60 (1962).

purchaser to buy the security, the exemption is lost. On the other hand, the fact that he solicits the seller to *sell* the security does not destroy the exemption.[27]

The prohibition against solicitation of buy orders poses some problems. First of all, with respect to stock exchange transactions, where a public "auction" occurs prior to a completed purchase and sale, the execution of an ordinary sell order does not constitute solicitation of an order to buy. Similarly, an institutional advertisement by a brokerage firm would not constitute the solicitation of an order to buy any particular security. But suppose that the broker discusses the security in a market letter or, even though he gives no advice or recommendation concerning a security, informs his clients by mail that the security is being offered and proffers his services in purchasing that security. Certainly these activities would amount to solicitation of buy orders. With respect to transactions in unlisted securities, paragraph (d) of Rule 154 provides: "Where within the previous 60 days a dealer has made a written bid for a security or a written solicitation of an offer to sell such security, the term 'solicitation' in Section 4(2) shall not be deemed to include an inquiry regarding the dealer's bid or solicitation." The term "written bid" obviously includes bids in the National Daily Quotation Sheets ("pink sheets") as well as other written bids of any type. Conversely, asking a broker who has no bid on the security in the sheets or other writing would constitute solicitation of an order to buy. Pertinent comments by the Commission on this portion of the rule are reproduced in the margin.[28]

Suppose that the solicitation of a buy order is conducted without using either the mails or facilities of interstate commerce, but that the resulting *sale* involves use of such means. Is the exemption available? On this point the Commission has taken the position that solicitation of a buy order by *any means* prevents the application of the exemption to any subsequent step taken to complete the sale or delivery after sale.[29]

27. "[T]his construction is based on the fact that the statute is designed primarily for the protection of buyers rather than for the protection of sellers." SEC Securities Act Release No. 3421, Aug. 2, 1951. Rule 154(c) expressly provides: "The term 'solicitation of such orders' in Section 4(2) of the Act shall be deemed to include the solicitation of an order to buy a security, but shall not be deemed to include the solicitation of an order to sell a security."

28. While paragraph (a) of the rule makes it clear that there is no exemption for the solicitation of orders to buy, a question remains as to what constitutes 'solicitation' where a broker for a seller approaches a dealer who is bidding for the security or solicitating orders to sell it to him. Paragraph (b) [now (d)] of the rule provides that where the dealer's solicitation or bid is *in writing*, the broker's inquiry about it is not a 'solicitation' within the meaning of Section 4(2). Paragraph (b)[d] recognizes also that, in the over-the-counter market, dealers interested in buying a particular security may not publish a quotation on indication of interest in it every day or every week. To some extent such quotations are published in monthly services, and to allow for the delays incident to such publications the rule provides, in effect, that the brokers can rely on bids or indications of buying interest originating as much as 60 days previously as indicating that a dealer is *soliciting sell orders*, so that the broker, in calling the dealer, would not be deemed to be soliciting him. SEC Securities Act Release No. 3421, *supra* note 27.

29. See Brooklyn Manhattan Transit Corp., 1 S.E.C. 147, 171 (1935).

D. *Broker Must Not Be Aware that Principal is Underwriter or that Distribution is in Progress*

As has been stated by the Chief Counsel of the Commission's Division of Corporation Finance:

> If a controlling person is barred by the Act from selling his stock without registration for any reason other than merely being a controlling person (as in the case where he would be a statutory underwriter by reason of his receiving shares pursuant to a purported private offering but not holding the shares for investment or in the case where he recently exercised a stock option) then Rule 154 will not permit the sale of his shares without prior registration or qualification under Regulation A. In such an instance, the controlling person is a statutory underwriter.[30]

The taking of securities for investment concerns the private offering exemption in the second clause of Section 4(1),[31] but the point is that the Commission takes the position that Section 4(2) and Rule 154 are not available for investment stock or, for that matter, for any situation where the seller may not sell his unregistered securities "for any reason other than merely being a controlling person."[32] In other words, in such situations the seller is an underwriter and the broker participates in the distribution, thus making him an underwriter also. Accordingly, if the broker is aware that his principal is an underwriter, as the rule specifies, the Section 4(2) exemption is not available. Similarly, the exemption under the first clause of Section 4(1) would not be available to the seller. Thus, it is apparent that in determining whether the brokers' transactions exemption is available, the exemption relied on by the controlling seller must be examined.

In sum, in order to avail himself of the exemption, 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. A reasonable investigation presupposes reasonable inquiries by the broker concerning the pertinent facts and circumstances with respect to the controlling person and the proposed transaction. In this connection, reference is made to an important Commission release.[33]

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30. Lese, *supra* note 19.

31. "[T]ransactions by an issuer not . . . involving any public offering . . . ."

32. Similarly, if the controlling person acquires his securities as the result of a merger or consolidation, Rule 154 is not applicable. But such a controlling person's sales may be exempted under Rules 133(d) and (e).

33. SEC Securities Act Release No. 4445, Feb. 2, 1962. See also Israels, *Checklist for Broker-Dealer Inquiry as to Customer's "Control" or "Underwriter" Relationship; Or Where Sale of Securities Proposed in "Brokerage Transaction" in Reliance Upon S.E.C. Rule 154,* 18 BUS. LAW. 94 (1962); Skiatron Electronics & Television Corp., SEC Securities Act Release No. 4282 (Oct. 3, 1960). In SEC v. Mono-Kearsage Consol. Mining Co., 167 F. Supp. 248, 255 (D. Utah 1958), where the *issuer* merely took the word of "investment buyers," the

E. *Quantitative Limitations: The "One Per Cent Rule"*

Paragraph (b) of Rule 154 represents an attempt to distinguish between "trading" and "distribution." First, the paragraph provides that the term "distribution" is not applicable "to transactions involving an amount not substantial in relation to the number of shares or units of the security outstanding and aggregate volume of trading in such security." Then, in effect, it permits casual trades by controlling persons to the amount of approximately one per cent of the outstanding securities of the issuer within any six-month period, except that where the security is listed on a national securities exchange, the controlling person can sell up to the *lesser* of approximately one per cent of the outstanding shares *or* of the largest aggregate reported volume of trading on the exchange during any one week within the four calendar weeks preceding the receipt of the sell order. Thus if in addition to satisfying the four conditions previously discussed, these quantitative limitations are observed, there is no "distribution" and the exemption is available.

Several interpretative problems arise when the one per cent formula is applied. First, it should be noted that the rule uses the word "approximately." It is probable, then, that sales by a controlling person slightly in excess of the one per cent figure would qualify for the exemption.

Secondly, may a controlling person sell the maximum one per cent in as many successive six-month periods as he wishes? Although the Commission has taken no official position on this point, the writer is informed that the staff of the Commission, realizing that such continuous activity has all the attributes of a "bailout" pattern, feels that a "distribution" is involved and that the exemption is not available.[34] Assuming this position to be correct, it will behoove the broker to inquire concerning sales by the controlling person during the preceding six months and his intended future sales of the security. Such an inquiry will bear directly upon his "awareness" of a distribution and consequent availability or loss of the exemption.

The next question for consideration concerns what sales must be included in the one per cent computation. On this point, paragraph (b) provides that "the term 'distribution' shall not be deemed to include a sale or series of sales of securities which, *together with all other sales* of securities of the same class" do not exceed the percentage or volume limitations of the regulation. (Italics added.) In other words, *all sales by a controlling person within the preceding six months under an exemp-*

court stated: "[A]n issuer cannot take at face value the assurance of buyers that they buy only for investment purposes when circumstances would show to a reasonable person that these assurances are formal rather than real."

34. Query: What amounts to a "pattern"? 1% sales in more than two successive six-month periods? It is most difficult to draw any precise line between "trading" and "distribution" in such situations.

tion or even a registration statement must be included in the one per cent calculation. By way of illustration, suppose that X, a controlling person, has sold during the past six months in excess of one per cent of his company's outstanding common stock in a Regulation A offering. The Section 4(2) exemption as implemented by Rule 154(b) is not available for additional sales. Similarly, suppose that X sells in excess of one per cent in an intrastate offering under the Section 3(a)(11) exemption or in a direct private placement under the second clause of Section 4(1). In neither of these cases is the rule available for additional sales. Finally, suppose that X has sold during the past six months five per cent of his company's outstanding common stock under a registration statement and now seeks to sell an additional one per cent in a brokerage transaction under the rule. The exemption is not available.[35] These computation principles serve to reemphasize the necessity of reasonable precautionary measures by way of inquiry on the part of the broker before executing a proposed sale for a controlling person.[36]

Closely related to the foregoing computation problems is the question of *whose* stock must be included in the one per cent calculation. To put it another way, is Rule 154 available for brokerage transactions involving more than one controlling person during any six-month period? Paragraph (b) of the rule refers to "sales . . . by or on behalf of the same person." It is clear that where more than one individual is in a control relationship and those individuals are not related through family, contractual or economic ties and do not have joint ownership of the securities, each such individual is a "person" for purposes of the one per cent ceiling. Conversely, where such "group" factors are present, it is highly probable that all individuals in the control group constitute one "person" for computation purposes.[37]

VII. Conclusion

Section 4(2) as implemented by Rule 154 warrants careful study. Under certain circumstances the section and the rule may provide a welcome avenue for legal avoidance of the registration and prospectus requirements of the Act. But cautious attorneys for both controlling

35. Conversely, however, since Rule 154 speaks in terms of "all other sales . . . within the *preceding* period of six months," it appears that the controlling person can sell the 1% under the rule and *subsequently* sell additional securities of the same class under a registration statement.

36. See authorities cited note 33 *supra*. A question that remains unanswered at the present time is whether shares which have been *pledged* and upon which there has been no default or foreclosure would have to be included in the 1% computation. The answer, of course, depends upon whether a bona fide pledge is a "sale" within the meaning of the rule. See SEC v. Guild Films Co., 279 F.2d 485 (2d Cir.), *cert. denied sub nom.*, 364 U.S. 819 (1960).

37. Section 2(2): "The term 'person' means an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization or a government or political subdivision thereof."

persons and brokers should weigh all pertinent facts surrounding the proposed transaction before giving a green-light opinion. Otherwise, illegal evasion and serious consequences may follow. It is hoped that the discussion contained in this article may aid the attorney in advising his clients in this important area of securities regulation.