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Sale of Securities by "Controlling Persons" Under the Federal Securities Act

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SECTION 5[1] of the Securities Act of 1933[2], herein called the Act, is ubiquitous. Unless a registration statement is on file with the Securities and Exchange Commission and in effect with respect to a security, this section prohibits the offer, sale, or delivery of any security by mail or in interstate commerce. By its terms this prohibition applies, among other things, to any offer or sale of securities by any security holder of a corporation,[3] whether public or private. Furthermore, the burden of proof of entitlement to exemption is on the one who would plead it.[4]

Filing a registration statement is expensive and time consuming. It may subject the corporation to certain reporting commitments[5] and the directors to certain civil liabilities.[6] It may also compel the extensive disclosure of information concerning the corporation, including audited historical financial statements[7] which may not be readily available. If the amount involved is not to exceed $100,000, the filing may be made pursuant to the exemption provided in section 3(b) of the Act,[8] but such a filing is also time consuming and relatively expensive, compels disclosures and has other possible disadvantages. In any event the filing cannot be made directly by the selling security holder, but only by the corporation on his behalf and perhaps at his expense.

These requirements are not to be taken lightly, for any person who

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1 68 Stat. 684 (1954), 15 U.S.C. § 77e (1958).

2 48 Stat. 74 (1933), 15 U.S.C. §§ 77a-77aa (1958).

3 Or other issuer, as defined by Securities Act of 1933 § 2(4), 68 Stat. 683 (1954), 15 U.S.C. § 77b(4) (1958).

4 S.E.C. v. Ralston Purina Company, 346 U.S. 119 (1953); S.E.C. v. Gilligan Will and Co., 267 F.2d 461 (2d Cir. 1959), *cert. denied*, 361 U.S. 896 (1959).

5 Securities Exchange Act of 1934 § 15(d), 48 Stat. 881 (1934), 15 U.S.C. § 78o(d) (1958).

6 Securities Act of 1933 § 11, 48 Stat. 907 (1934), 15 U.S.C. § 77k (1958).

7 *E.g.*, Securities Act of 1933 Schedule A, 48 Stat. 88, 91 (1933), 15 U.S.C. § 77aa (1958); and Form S-1, Instructions as to Financial Statements.

8 See, Frank, *The Processing of Small Issues of Securities Under Regulation A*, 1962 DUKE L.J. 507.

wilfully violates the Act is subject, upon conviction, to imprisonment for up to five years[9] (although in practice section 5 violations are not prosecuted unless there is a tinge of fraud). If a sale violates section 5, the buyer has a civil action for rescission against the seller.[10] Finally, a sale by a "controlling person" in violation of section 5 may be enjoined by a United States district court at the petition of the Securities and Exchange Commission.[11]

The apparent harshness of the Act is greatly relieved by section 4[12] of the Act which excludes most of the usual transactions of the ordinary investor from the requirements of section 5. A "controlling person" cannot so cavalierly avoid section 5, but he may look to section 4 as a possible exemption for his security sales. Section 4, however, will not insulate a seller from *civil* liability under section 12(2)[13] of the Act for the offer or sale of a security by the use of false or misleading statements, for omissions of fact, or for violations of the general prohibitions against fraud in section 17[14] of the Act.

Among the class of private investors, Congress was particularly concerned with sales by "controlling persons":[15]

> All of the outstanding stock of a particular corporation may be owned by one individual or a select group of individuals. At some future date they may wish to dispose of their holdings and to make an offer of this stock to the public. Such a public offering may possess all the dangers attendant upon a new offering of securities. Wherever such a redistribution reaches a significant proportion, the distributor would be in the position of controlling the issuer and thus able to furnish the information demanded by the bill. This being so, the distributor is treated as equivalent to the original issuer and, if he seeks to dispose of the issue through a public offering, he becomes subject to the Act.

"Control"[16] is not defined in the Act. The commission has called it the possession 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."[17] Control may rest with

[9] Securities Act of 1933 § 24, 48 Stat. 87 (1933), 15 U.S.C. § 77x (1958).

[10] Securities Act of 1933 § 12(1), 68 Stat. 686 (1954), 15 U.S.C. § 77(L) (1) (1958).

[11] S.E.C. v. Micro Moisture Controls, Inc., 167 F. Supp. 716 (S.D. N.Y. 1598), *aff'd sub nom.* S.E.C. v. Culpepper, 270 F.2d 241 (2d Cir. 1959).

[12] 68 Stat. 684 (1954), 15 U.S.C. § 77d (1958).

[13] 68 Stat. 686 (1954), 15 U.S.C. § 77(l) (2) (1958).

[14] 68 Stat. 686 (1954), 15 U.S.C. § 77q (1958).

[15] H.R. Rep. No. 85, 73d Cong., 1st Sess. 13, 14 (1933).

[16] As used in Securities Act of 1933 § 2(11), 68 Stat. 683 (1954), 15 U.S.C. § 77b(11) (1958).

[17] 17 C.F.R. § 230.405. This definition, strictly speaking, applies only to a registration but it is in context and is a useful guide.

a group of persons[18] and, for the purposes of the Act, *each member* of the group may be considered to have control. Among the factors to be considered are the number of shares held (although a 51% ownership, of course, is not necessary),[19] the number of representatives on the board of directors or as officers, and control of the proxy machinery.

For the purpose of measuring control in the light of the above quoted Congressional statement, the most useful test, and the one generally used by the commission in these circumstances, is whether the selling security holder can cause the corporation to file, at his expense, a registration statement on his behalf. If he cannot, then he does not have control for these purposes and he should be treated as an ordinary investor.

If a controlling security holder sells his voting stock interest over a period of time there may come a point in the distribution when he is no longer a "controlling person." However, if the securities sold after control has passed are part of the same issue as those which were sold before control passed, then the seller would presumably be regarded as a "control person" until distribution of the entire issue was completed.[20]

The First Clause Exemption

Direct Sales

Section 5 does not, by the terms of the first clause of section 4(1) of the Act, apply to "transactions by any person other than an issuer, underwriter or dealer."[21] By definition[22] the usual transaction of an investor has been placed beyond the registration requirements of the Act. No security holder, not even a "controlling person," falls within these categories.

"Underwriter" is defined in section 2(11) as:

> [A]ny 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, . . . As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or

[18] See H.R. Rep. No. 85, 73d Cong., 1st Sess. 13-14 (1933).

[19] *Id.* at 14; Thompson Ross Securities Co., 6 S.E.C. 1111 (1940).

[20] An "insider," whether or not he is a control person, may also have a fiduciary obligation toward a purchaser under state law, and if the corporation is listed on a national securities exchange such an insider would be subject to the liability for short swing profits imposed by section 16 of the Securities Exchange Act of 1934, 48 Stat. 896 (1934), 15 U.S.C. § 78p (1958); *cf.* 17 C.F.R. 240.10b-5 (implied liabilities under Rule 10b-5 of this statute).

[21] Securities Act of 1933 § 4(1), 68 Stat. 684 (1954), 15 U.S.C. § 77d(1) (1958).

[22] Securities Act of 1933 §§ 2(4), (11), (12), 68 Stat. 683 (1954), 15 U.S.C. §§ 77b(4), (11), (12) (1958).

controlled by the issuer, or any person under direct or indirect common control with the issuer.

Thus an underwriter, even a statutory underwriter (one by definition rather than by profession), cannot claim the protection of the first clause of section 4(1) where there is a purchase from a "controlling person." Purchasers should therefore take measures to avoid being considered statutory underwriters. But what about the selling, "controlling," security holder? Shall the father go unfettered if we condemn the unwed mother for her issue?

The answer is "no." If a purchaser from a "controlling person" is deemed to be a statutory underwriter then the first clause exemption is lost to the "controlling person" as well. That is clearly established. But since this does not accord with a literal reading of the statute, how do we get there from here? For the most part the result has simply been assumed[23] and it is certainly consistent with the Congressional scheme.

Perhaps the cleanest approach is to consider the selling "controlling person" as an aider and abettor[24] under the criminal code.[25] A second approach is to face it out as a matter of statutory interpretation. Even if the "controlling person" is not an "issuer, underwriter or dealer," he is participating in a transaction with an underwriter and the first clause of section 4(1) does not apply to the component parts of the transaction. The exemption does not by "fair implication" protect those engaged in steps necessary to the distribution of a security issue.[26]

The limiting factor for the "controlling person," then, is whether his sale or the subsequent resale by the purchaser (or related series of sales and resales) is a "distribution" within the meaning of section 2(11) of the Act.

A selling "controlling person" can protect himself by taking precautions against such sales and resales constituting a public offering. If he does so he can be certain that a purchaser from him will not be deemed to be a statutory underwriter. That is, he should obtain an investment representation from his purchasers, limit the number of offerees, make financial and other related information about the corporation available to the offerees, exclude brokerage firms from the offerees, and so forth.

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[23] See Skiatron Electronics and Television Corp., Securities Act Release No. 4282 (Oct. 3, 1960).

[24] S.E.C. v. Micro Moisture Controls, 167 F. Supp. 716 (S.D. N.Y. 1958), *aff'd sub nom.* S.E.C. v. Culpepper, 270 F. 2d 241 (2d Cir. 1959).

[25] 65 Stat. 717 (1951), 18 U.S.C. § 2 (1958).

[26] Chinese Consolidated Benevolent Ass'n, Inc., 120 F.2d 738, 741 (2d Cir. 1941), *cert. denied,* 314 U.S. 618, (1941). See S.E.C. v. Culpepper, 270 F.2d 241 (2d Cir. 1959).

A selling stockholder will find it more difficult than an issuer to separate several offerings into distinct issues. However, as we shall see shortly, a "distribution" within the meaning of section 2(11) may be broader than the second clause of the section 4(1) concept of public offering.

Sales Through Brokers

There are no special provisions governing sales by a "controlling person" through a dealer except when the sales are "brokers' transactions" as defined in rule 154[27] and section 4(2) of the Act.[28] In such a case the "controlling person" will be an incidental beneficiary of the only reasonably certain standards in section 4 of the Act.

Section 4(2) of the Act was drafted to exempt ordinary brokers' transactions.[29] The section exempts only the broker and not the selling customer.[30] A selling security holder (whether or not he is a "controlling person") may avail himself of the exemption of the first clause of section 4(1). Both the broker and the "controlling person" will lose their respective exemptions if the broker is acting as an underwriter. Rule 154 concerns only transactions for the account of a "controlling person." Since a private person is never an "issuer," except within the meaning of section 2(11), the broker cannot then be a statutory underwriter. Because a corporation is an issuer and has no exemption for its side of the transaction if there is a public offering (which a sale through a broker almost invariably includes), there was no need for the rule to be occupied with such transactions.

[27] Rule 154 defines a "brokers' transaction" in section 4(2) to include transactions of sale executed by a broker for the account of any controlling person where (1) the broker performs no more than the usual and customary broker's function, (2) receives no more than the usual and customary commission, (3) neither he, nor to his knowledge his principal, solicits orders to buy, and (4) he is not aware of circumstances indicating that his principal is an underwriter or engaged in the distribution of securities.

For the purpose of this rule "distribution" shall not apply to "transactions involving an amount not substantial in relation to the number of shares of units of the security outstanding and the volume of trading in the security." This includes all sales by a person of a class of securities within six months not exceeding approximately (1) 1% of such outstanding securities or (2) if listed on an exchange the lesser of (1) and the largest aggregate volume of trading during any one of the preceding four weeks. Rule 154, 17 C.F.R. 230.154.

[28] Securities Act of 1933 § 4(2), 68 Stat. 684 (1954), 15 U.S.C. § 77d(2) (1958): "Section 5 shall not apply to brokers' transactions."

[29] H.R. Rep. No. 85, 73d Cong., 1st Sess. 16 (1933).

[30] See Skiatron Electronics and Television Corp., Securities Act Release No. 4282 (Oct. 3, 1960).

As the Commission noted in *Ira Haupt and Co.*:[31]

> Just as an "underwriter" acting as such cannot be encompassed by the term "dealer" as used in the third clause of Sec. 4(1), he is similarly not within the scope of the term broker as used in Sec. 4(2)[32]—i.e., the fact that a person is an "underwriter" acting as such is conclusive in indicating that he cannot at the same time be considered as a dealer or broker under Sec. 4(1) or 4(2).

The Commission subsequently promulgated rule 154[33] as an "aid in determining when transactions by brokers are routine trading transactions within the brokers' exemption of section 4(2) and when such transactions may be part of a distribution of securities by the brokers' principal and not exempt as 'brokers' transactions' "[34]—that is, when the broker is acting as an underwriter rather than as a dealer. This is the so called "1% Rule." In general, it will not, for the purpose of defining a "brokers' transaction" in section 4(2), treat as a "distribution" a sale by a "controlling person" which does not exceed, during a six month period, 1% of the outstanding securities of the class of security sold. It is understood that the Commission considers the 1% figure to be available for each "controlling person" (unless they act in concert, or perhaps if they are part of the same family or other closely intertwined group); but such sales include all unregistered (and possibly registered) sales of the "controlling person" during the six month period regardless of whether an exemption was available. Moreover, the rule will not necessarily be applicable to 1% distributions in successive six month periods which, when viewed together, appear to represent a concerted effort at a distribution.

Beside furnishing the "controlling person" a broker who will reasonably hazard a brokerage sale for him, rule 154 also defines, under the rationale of the *Ira Haupt* decision, the term "underwriter" in the first clause of section 4(1) of the Act for the purpose of a transaction coming within the provisions of rule 154. If a dealer is not an underwriter for the purposes of section 4(2), he would not in the same transaction be an underwriter for the purpose of section 4(1), and the "controlling person" would consequently be exempt. The same reasoning which made the exemption of the first clause of section 4(1)

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[31] 23 S.E.C. 589, 604 n. 23 (1946).

[32] "The provisions of Section 5 do not apply to . . . transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the securities involved in such transaction) . . ." Securities Act of 1933 § 4(1), 68 Stat. 684 (1954), 15 U.S.C. § 77d(1) (1958).

[33] Securities Act Release No. 3525 (Dec. 22, 1954).

[34] Skiatron Electronics and Television Corp., Securities Act Release No. 4282 (Oct. 3, 1960).

unavailable to a "controlling person" when it was unavailable to his statutory underwriter cannot withhold it from the "controlling person" when his purchaser or agent is acting permissively. We have not explored what constitutes allowable brokerage activity, but suffice it to say that it is sufficiently complex for a prudent "controlling person" to advise his broker that he is such whenever he sells in that capacity.

Regardless of whether a broker for a "controlling seller" is a statutory underwriter, if such a "controlling seller" is a statutory underwriter because he has violated an investment representation, the exemption of the first clause of section 4(1) is not available to him. Rule 154 will not terminate an investment commitment.

Finally, if a broker is aware, or reasonably should be aware,[35] that his principal is an underwriter with respect to the securities, then he will be a statutory underwriter and the first clause exemption will not be available to the selling "controlling person."

Pledges

There is no specific exemption in the Act for a pledge or a foreclosure sale of pledged securities. Is a bona fide pledge, then, normally made with a view towards a public offering or a distribution? Presumably not. A bank, or other institutional lender, is in the business of lending money and not that of selling securities. At least it seems to be a question of fact which should await the event of foreclosure for determination. Until that time the pledgor will have the option of discharging the loan or substituting collateral.

The foreclosure sale is something else again. If the bank or other pledgee of the securities of a "controlling person" is deemed to be a person who has "purchased with a view to" distribution or "offers or sells for" a "controlling person" in connection with a distribution within the meaning of section 2(11), such pledgee will be a statutory underwriter. A pledge is a disposition for value[36] and hence "purchased," as used in section 2(11); purchased, though not defined in the Act, has been interpreted as complementary to "sale."[37] If, then, the foreclosure sale constitutes a distribution, the pledgee will be a statutory underwriter and the "controlling person" cannot avail himself of the exemption of the first clause of section 4(1).

[35] Securities Act Release No. 3525 (Dec. 22, 1954); *cf.*, Securities Act Release No. 4445 (Feb. 2, 1962).

[36] S.E.C. v. Guild Films Company, Inc., 279 F. 2d 485 (2d Cir. 1960), *cert. denied sub nom,* Santa Monica Bank v. S.E.C., 364 U.S. 819 (1960).

[37] *Ibid.*

"A sale by the pledgee is, of course, pursuant to a power of sale granted by the owner; and such a pledge may often operate in practical effect as a 'stop loss' order—an order to a broker to sell if the market value of the securities drops below a specific price."[38] One exercising the prerequisites and receiving the benefits of ownership should not so easily avoid the requirements of registration by the form chosen for the particular transaction.[39] Nor does the good faith of the pledgee place the transaction beyond the definition of a statutory underwriter when it is engaged in steps necessary to a public sale. The statute does not impose such a criterion. To a purchaser, it is not a substitute for the information he is entitled to under the Act.[40]

The Second Clause Exemption

Probably the most common way for a "controlling person"[41] to obtain his interest in a corporation is in a transaction "by an issuer not involving a public offering," because this exempts the issuer from the provisions of section 5, pursuant to the second clause of section 4(1).[42] This is particularly true of securities obtained during the formative stages of a corporation. By accepting unregistered securities in reliance on the exemption of the second clause of section 4(1) of the Act, a security holder commits himself to certain restrictions as to their subsequent sale. That is, the exemption is founded on the fact that he is taking these securities for investment. For if he purchases the securities with a view towards distribution, or a public offering, the issuer's exemption will be lost. The exemption of the first clause of section 4(1) will not be available to the purchaser, in the first instance, because he would himself be a statutory underwriter and, in the second instance, because he would be participating in an illegal sale with an issuer (under the same rationale which deprives a "controlling person" of the exemption of the first clause of section 4(1) when his purchaser is a statutory underwriter).

The determination of what constitutes a public offering is essentially a question of fact.[43] The Supreme Court, in *S.E.C. v. Ralston Purina*

[38] Surface Transit, Inc. v. Saxe, Bacon and O'Shea, 266 F.2d 862, 867 (2d Cir. 1959).

[39] *Cf., ibid.*

[40] S.E.C. v. Guild Films Company, Inc., 279 F.2d 485 (2d Cir. 1960); Skiatron Electronics and Television Corp., Securities Act Release No. 24282 (Oct. 3, 1960). In both cases, however, the pledges were in fact not bona fide.

[41] This discussion is also applicable to noncontrolling security-holders who purchase from an issuer for investment.

[42] Securities Act of 1933 § 4(1), 68 Stat. 684 (1954), 15 U.S.C. § 77d(1) (1958).

[43] Opinion of General Counsel, Securities Act Release No. 285 (Jan. 24, 1935).

Co.,[44] would not, as a matter of statutory interpretation, draw a numerical limit on private offerings but said that the statute would "apply to a 'public offering' whether to few or to many."[45] The Court seemed more concerned with the need for protection of the particular class of persons affected: "The focus of the inquiry should be on the need of the offerees . . . to have access to the kind of information which registration would disclose."[46]

The number of offerees and their relationship to each other and to the issuer, rather than the number of purchasers, is the basic factor.[47] In an early opinion the general counsel stated that "under ordinary circumstances an offering to not more than 25 persons . . . presumably does not involve a public offering. . . . [But] in no sense is the question to be determined exclusively by the number of prospective offerees."[48] This generalization is probably still a fair reflection of the commission's view.[49]

Further, it is the number of ultimate offerees that counts.[50] Therefore, it is important to be sure that the offering comes to rest with the original purchasers or soon after, or, in other words, that they acquire the securities for investment.[51] This is governed by the intention of the purchaser at the time of his purchase but it is measured by external facts.[52] This is the purpose, for example, of the investment letter—a self-serving, contemporaneous representation by the purchaser which is commonly requested by the issuer. It is evidentiary, but not conclusive.[53] Again, if a stop transfer order is, with the purchaser's consent, placed simultaneously with the transfer agent and an appropriate restrictive legend is placed on the face of the certificate to make the stop order effective under the Uniform Stock Transfer Act, there is a further reflection of a genuine investment intent. These steps will also help

[44] 346 U.S. 119 (1953).

[45] *Id.* at 125.

[46] *Id.* at 127.

[47] Opinion of General Counsel, Securities Act Release No. 285 (Jan. 24, 1935); Securities Act Release No. 4552 (Nov. 6, 1962).

[48] Opinion of General Counsel, *supra* note 47.

[49] See When Corporations Go Public 15-16 (Israels and Duff, ed., 1962) (statement of Mr. Shreve).

[50] Crowell-Collier Publishing Co., Securities Act Release No. 3825 (Aug. 12, 1957); see Gilligan Will and Co. v. S.E.C., 267 F.2d 461 (2d Cir. 1959).

[51] *Ibid.* See, Israels and Duff, *op cit supra*, note No. 49, at 17-19 (Statement of Mr. Shreve).

[52] *Cf.*, Opinion of General Counsel, Securities Act Release No. 1862 (Dec. 14, 1938).

[53] *Ibid. Cf.*, Crowell-Collier Publishing Co., Securities Act Release No. 3825 (Aug. 12, 1957); Gilligan Will and Co. v. S.E.C., 267 F.2d 461 (2d Cir. 1959).

the issuer to retain effective control over the scope of the offering.[54] Most prominent among the relevant and objective evidentiary factors is the length of time which elapses between the acquisition of the securities and the proposed resale.[55] The present administrative view seems to be that retention for a period of from one[56] to two[57] years is fair evidence of an investment intent. A change in the personal circumstances of the purchaser would permit an earlier sale without casting doubt on the genuineness of the original investment intent, but not a change in the financial situation of the issuer.[58]

Other factors which tend to make an offering appear public are the presence of broker-dealer firms among the original purchasers,[59] use of a bearer form of security,[60] issuance of several smaller denomination certificates to a purchaser instead of a single one of larger denomination,[61] the size of the offering[62] and the speculative nature of the security.[63] The size of the offering, the number of offerees and other related factors refer separately to each integrated issue of securities.

If an alleged investment purchaser has in fact acquired his securities with a view to distribution (which may not be quite the same as an intent to make a public offering) he will be deemed a statutory underwriter, and the exemption of the first clause of section 4(1) will not be available to him for the resale of his own securities. An investor may normally resell to another, for investment purposes only, without violating his own investment representation although the aggregate number of offerees for the issue of securities will be increased by the number of such purchasers.

The criteria which distinguish a private from a public offering will also describe the apogee beneath which a transaction or series of transactions is not a distribution, whatever may lie in the stratosphere beyond.

Distribution—Distinguishing the First and Second Clause

We have seen that a "controlling person" can be assured that a sale by him of the securities of his controlled corporation will not

[54] Crowell-Collier Publishing Co., Securities Act Release No. 3825 (Aug. 12, 1957).

[55] *Cf.*, Opinion of General Counsel, Securities Act Release No. 1862 (Dec. 14, 1938).

[56] *Ibid.*

[57] See, U.S. v. Sherwood, 175 F. Supp. 480 (S.D. N.Y. 1959).

[58] Gilligan Will and Co. v. S.E.C., 267 F. 2d 461 (2d Cir. 1959).

[59] Crowell-Collier Publishing Co., Securities Act Release No. 3825 (Aug. 12, 1957); Opinion of General Counsel, Securities Act Release No. 1862 (Dec. 14, 1938).

[60] Crowell-Collier Publishing Co., Securities Act Release No. 3825 (Aug. 12, 1957).

[61] Opinion of General Counsel, Securities Act Release No. 285 (Jan. 24, 1935).

[62] *Ibid.*

[63] Crowell-Collier Publishing Co., Securities Act Release No. 3825 (Aug. 12, 1957).

be a "distribution" if he takes care to see that it is not a public offering. Although not expressly defined in the Act, the Commission has defined "distribution" as "the entire process by which in the course of a *public offering* a *block* of securities is dispersed and ultimately comes to rest in the hands of the investing public."[64] (Emphasis added.) Thus, unless there is a public offering, there is no distribution. But, are the words synonymous or does the term "distribution" give a broader scope to the exemption of a "controlling person" under the first clause of section 4(1) than "public offering" gives to the issuer under the second clause of section 4(1)?

When the Commission defined "distribution" it significantly used the term "block." Congress, in describing a distribution which would subject a "controlling person" to the registration requirements of the Act, used the term "significant proportions."[65] Also, Congress did not add "controlling person" to the category of "issuer, underwriter or dealer" in the first clause of section 4(1) nor did it use that term in referring to an "issuer" in the second clause of that section. Since Congress avoided this obvious, direct approach it is reasonable, therefore, to suppose that a deliberate distinction was intended between the exemption in section 4(1), available to an issuer, and that which is available to a "controlling person."

Almost the entire thrust of section 2(11),[66] in which "distribution" is used to define an "underwriter," is directed toward describing a professional underwriter; *i.e.*, one who is selling, or is in the business of selling, substantial or at least significant quantities of securities. There is no implication that a private investor may not be, as we have considered him before, a statutory underwriter. That is surely the law. Rather, can we distinguish, at least, between the offer of one share of treasury stock by a corporate issuer on an exchange (a public offering),[67] which offer deprives the issuer of the exemption of the second clause of section 4(1) of the act, and a similar offer (or sale) by a "controlling person"?

[64] Oklahoma-Texas Trust, 2 S.E.C. 764, 769 (1937), *aff'd sub nom; accord,* Oklahoma-Texas Trust v. S.E.C., 100 F.2d 888 (2d Cir. 1939); Lewisohn Copper Corp., 38 S.E.C. 226 (1958); Ira Haupt and Co., 23 S.E.C. 589, 597 (1946).

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

[66] "The 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 . . . in any such undertaking, but such term shall not include a person whose interest is limited to a commission from an underwriter not in excess of the usual and customary distributors' or sellers' commission." Securities Act of 1933 § 2(11), 68 Stat. 683 (1954), 15 U.S.C. § 77b(11) (1958).

[67] Wilko v. Swann, 127 F. Supp. 55 (S.D. N.Y. 1955).

The Commission's definition of "distribution" contemplates a sale, and perhaps a resale, of a block of securities. A public offering by an issuer does not require any sale to remove it from the exemption of the second clause of section 4(1). Moreover, one who purchases from a "controlling person" with a view to distribution, but who has not yet formulated his plan of distribution or does not intend an *immediate* resale, may not file a registration statement because it would be a registration for the shelf.[68] This is not illegal, for the statutory pattern does not contemplate making an act criminal before that compliance which it contemplates can be consummated. On the other hand, if the purchasers from an issuer in an allegedly private offering do not take for investment, then there *can* be an immediate violation of section 5.

In justifying the application of the registration provisions of the Act to a controlling person, the Commission in the *Ira Haupt* case said:[69]

> These sections [2(11) and 4(1)] by their terms provide that whenever anyone controlling an issuer makes a public distribution of his holdings in the controlled corporation by selling through another person acting for him in connection with the distribution, the sales by which the distribution is accomplished are transactions by an underwriter which are subject to the registration requirements. Applied to such transactions by which *substantial* quantities of securities are disposed of to the public, the registration requirement is consistent with and calculated to further the general purpose of the Act to provide investors with pertinent information as a means of self protection. The legislative history of the Act strongly sustains this conclusion. [Emphasis added.]

Rule 154 would be absurd if "distribution" were equated with "public offering," because the public offering of even an inconsequential number of securities would turn the broker into a statutory underwriter and deprive him of the section 4(2) exemption. The broker would not need a routine guide to determine whether his principal was engaged in a distribution, but he need only know whether his principal was a controlling person. So when the commission came to define "distribution" for the purpose of rule 154 it defined it as "an amount not *substantial* in relation to the number of shares of the security or units of the security outstanding and the aggregate volume of trading in such security"[70]—that is, *securities* not *offerees.*

Thus it appears that a distribution is concerned with a sale of securities by means of a public offering. How many securities must be

[68] Securities Act of 1933 § 6(a) 48 Stat. 78 (1933), 15 U.S.C. § 77f(a) (1958).

[69] 23 S.E.C. at 601.

[70] 17 C.F.R. 230.154(b) (Emphasis added).

sold to constitute a distribution? Presumably this will be computed by the size of the issue and not the actual number of securities sold, provided that some securities are sold. The number of offerees is critical only to the determination of whether the distribution is in the course of a public offering. In other words, the "controlling person" of our illustration can sell his one share of stock (if that is the size of his issue) on an exchange pursuant to the exemption of the first clause of section 4(1). The next question is how many additional securities can he sell?

If the broker and "controlling person" comply with the provisions of rule 154 then the answer can be found in the "1% Rule." We have come full circle. But what if the broker does not comply with all the particulars of rule 154? Or what if the sale is not made through a broker? Rule 154 and its definitions apply, by its terms, only to section 4(2). Caution must surround any attempt to reason inductively from rule 154. There are particular restrictions on the broker which are designed to prevent solicitation or other sales activity and to prevent such a dealer from acting, or appearing to act, as a professional underwriter. A broker has a special problem in that he cannot stop to obtain a legal opinion for every transaction executed at the peril of losing his license. When acting innocently, he needs the insulating certainty of a fixed rule.

Although attended with some risk in circumstances that fall outside the boundaries of rule 154, a broker could sell publicly on behalf of a "controlling person" without being deemed an underwriter and thus find the section 4(2) exemption still available. Rule 154 is not exclusive. In such circumstances, the broker must rely on such general principles of "distribution" as were enumerated above; and he might well look for a guide to those principles which were apparently used in forging rule 154 and which have been mentioned.

A sale by a "controlling person" to private purchasers should be less of a "distribution" than a sale to, or through, brokers.[71] That being so, an unsolicited sale by a "controlling person" (which otherwise meets the requirements of rule 154 as far as it can be applicable) to a private purchaser should not be a "distribution" if a similar sale in a brokerage transaction would not be a distribution. While a broker could possibly be deemed an underwriter in circumstances where a private person might not, the reverse would indeed be strange. Analogies based on the 1% Rule should not range too far; but neither should they be

[71] *Cf.*, Crowell-Collier Publishing Co., Securities Act Release No. 3825 (Aug. 12, 1957); Opinion of General Counsel, Securities Act Release No. 1862 (Dec. 14, 1938).

completely dismissed. The logic of the rule that a "'distribution' shall not apply to transactions involving an amount not substantial to the number of shares or units of the security outstanding and the aggregate volume of trading in such security"[72] should still be pertinent.

This is what the Commission seems to say; but it has not yet said it explicitly. There are no sure guidelines. Once a "controlling person" walks beyond the protection of a non-public offering he must be very cautious.

Non Jurisdictional Sales

Section 5 applies only where a means of communication or instrument of transportation involving interstate commerce is used, or the mails are used, to offer, sell or deliver a security. Interstate commerce is defined by section 2(7)[73] of the Act as "trade or commerce in securities or any transportation or communication relating thereto among the several states . . . or between any foreign country and any state. . . ." Thus, where either party crosses a state line to effectuate the transaction, sends a related communication by telephone, telegraph or otherwise, delivers any security of the issue across a state line or makes any use of the mails, the jurisdictional requirement is met and section 5 and the entire act will be applicable. All of this is well establish. The remaining area of inquiry is what interstate acts may precede or follow an offer without being so much a part of it as to confer jurisdiction? Is payment by mail such a constituent part of the sale that it will confer jurisdiction? Is an interstate telephone call a communication in interstate commerce? Finally, if the security sold is part of a larger interstate issue then will the intrastate transaction be integrated with the entire issue and thus confer jurisdiction?

What Is An Issue?

If portions of a distribution could be segregated into a series of several smaller, separate offerings and sales so that a separate exemption would apply to each segment although it would not apply to the whole, then the registration requirements of the Act could be too readily avoided by accumulating exemptions.[74] The Commission's solu-

[72] 17 C.F.R. 230.154(b).

[73] 68 Stat. 683 (1954), 15 U.S.C. § 77b(7) (1958). The question of jurisdiction is one of the most litigated aspects of the Act and this discussion is only intended as a general summary. Except in the atypical situation where the transaction is clearly and exclusively intrastate, the selling "controlling person" would better rely on one of the exemptions in Section 4 of the Act, which is the main thrust of this article.

[74] Herbert R. May, 27 S.E.C. 814 (1948).

tion has been to integrate related offerings or sales. It is now well established that an exemption is valid only if it is available for the *entire issue.*[75]

When, then, is a series of transactions sufficiently related so that it can be integrated into a single issue for the purpose of determining the availability of the section 4(1) exemptions? Clearly, "when securities of the same class are offered for an identical purpose and on the same terms in an uninterrupted program of distribution."[76] Other considerations include the terms of sale and methods of distribution employed, and the purposes for which the proceeds are used.[77] As should be expected, each case must be determind on its own facts.[78]

Conclusion

The Act's restrictions on the sale of securities of a controlled corporation by a "controlling person" are at once greater than those which affect a "non-controlling" person and less than those which affect a corporation. Whether the securities to be sold were registered in the past is immaterial. If a transaction is not exempt, registration of the securities must be effective with respect to it.

When a "controlling person" acquires his securities for investment, pursuant to the exemption of the second clause of section 4(1) of the Act, he is bound, basically, by the same restrictions as is an issuer. Whether the offering is a public one will be a factual determination. The critical facts relating to offerees include their ultimate number, their relationship to each other and to the company, their need for information, and whether they include brokers, institutional investors or private persons.

At first glance, a "controlling person" might appear to be entitled to sell his securities in the same manner as a "non-controlling person" under the exemption of the first clause of section 4(1) of the Act. However, because of the definitions in section 2(11) such an exemption will not be available to him unless the securities were purchased for some purpose other than distribution.

The meaning of "distribution" is uncertain. It encompasses "public offering" and it also appears to involve the size of the offering; *i.e.*, the number of securities sold or to be sold as part of an issue in a given

[75] *Ibid.*; Unity Gold, 3 S.E.C. 618 (1938); Crowell-Collier Publishing Co., Securities Act Release No. 3825 (Aug. 12, 1957); Opinion of General Counsel, Securities Act Release No. 2029 (Aug. 8, 1939).

[76] Herbert R. May, 27 S.E.C. 814, 819 (1948).

[77] Unity Gold, 3 S.E.C. 618, 625 (1938).

[78] *Ibid.*

circumstance. Except where the securities are to be sold in a brokers' transaction which complies with the provisions of rule 154, the guide-posts are obscure.

There is a pattern to the Act, but the borders and many of the details are obscure. Some vagueness may be inevitable. Yet after thirty years there is still considerably more uncertainty than one would desire. This is a problem to which the eighty-eighth Congress might well turn its attention as it reviews the report of the Commission's Special Study of Securities Markets.