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THE INVESTMENT LETTER DILEMMA 
AND PROPOSED RULE 144: A RETREAT 
TO CONFUSION

William C. Morrow*

The last ten years have seen the greatest surge ever in the 
issuance of common stock of corporations without benefit of regis-
tration.¹ Many of these securities issues were legitimately made pur-
suant to an exemption from registration available under Section 4(2) 
of the Securities Act of 1933 in that the transactions were by "an 
issuer not involving any public offering."²

The Securities and Exchange Commission has stated that the 
purpose of this exemption has traditionally "... been regarded as 
providing an exemption from registration for bank loans, private 
placements of securities with institutions and the promotion of a 
business venture by a few closely related persons."³ Unfortunately, 
the practical application of this exemption has created uncertainty 
and confusion. In 1967, the Securities and Exchange Commission 
appointed a study group⁴ to review the whole range of problems 
being encountered by securities practitioners. They produced the 
Wheat Report,⁵ one section of which was the basis for Proposed 
Rule 160.⁶ This series of rules, however, was abandoned by the 
SEC, and now, securities practitioners who deal with investment 
letter stock are faced with a new proposal⁷ that threatens to con-
fuse an already uncertain practice.

The purpose of this article is first to discuss the situation as it 
effects now, then briefly summarize the proposed but abandoned

* B.A., Baylor University, 1957; J.D., Southern Methodist University, 1962; 
Member of the Texas Bar; Member of the Midland County, Texas Junior and Ameri-
can Bar Associations; Trial Attorney, United States Securities and Exchange Comis-

¹ This observation is made by the author as a consequence of concentrated work 
and analysis in the field of securities, dating from 1963.
(1962).
⁴ Id. No. 4845 (November 29, 1967).
⁵ FEDERAL SECURITIES LAW REPORTS, DISCLOSURE TO INVESTORS-A REAPPRAISAL 
OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (1969) [herein-
after cited as THE WHEAT REPORT].
⁷ Id. No. 5087 (September 22, 1970).
Rule 160 Series that appeared to clarify and resolve the problems, and finally to examine the present proposed Rule 144 and illustrate its compounding effects upon the current dilemma.

STATEMENT OF THE DILEMMA

Although the language of the Securities Act in Section 5⁸ is recognized as being equivalent to the Commandment, Thou Shalt Register, it is equally recognized that unlike a Commandment, there are exceptions to the rule.⁹ Section 4(2)¹⁰ of the Securities Act of 1933 was enacted for the purpose of providing a transactional exemption for the issuer of securities who is engaged in a distribution which is essentially a private financing transaction.¹¹ The statute does not define public offering, and whether a transaction is one not involving a public offering is a question of fact to be determined by considering all of the surrounding circumstances, including such factors as the relationship between the offerees and the issuer and the nature, scope, size, type and manner of the offering.¹² The burden of proving the availability of an exemption from registration is on the person claiming the exemption¹³ so that the issuer relying on Section 4(2) must look beyond the initial sale and be prepared to justify his claim.

The typical person selling a share of stock listed on a national exchange or traded over the counter may rely on the transactional exemption available under Section 4(1)¹⁴ of the Securities Act since his transaction is by "any person other than an issuer, underwriter or dealer."¹⁵ A person taking from an issuer under Section 4(2) and then reselling is clearly neither an issuer nor a dealer, although he may be an underwriter as defined in Section 2(11) of the Securities Act.¹⁶ Under the statutory definition of underwriter, ordinary investors may become underwriters if they act as mere conduits

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⁸ 15 U.S.C.A. § 77c(a) (1963). This Section prohibits the use of any instrument of transportation or communication in interstate commerce or of the mails to sell any security unless a registration statement is in effect.
⁹ There are two types of exemptions:
   (1) Those that exempt the security itself, such as are described in 15 U.S.C.A. § 77c (1963), and
   (2) Those transactional exemptions that are described in 15 U.S.C.A. § 77d (1970), and the intrastate offering exemption of § 77c (11).
¹¹ See note 3, supra, and accompanying text.
¹⁵ Id.
¹⁶ Id. § 77b(11) (1963).
through whom the securities flow into the hands of the public.\textsuperscript{17} Thus, any person who purchases a security from an issuer with a view to subsequent public distribution becomes an "underwriter"\textsuperscript{18} and does not have an exemption from registration under Section 4(1) upon his subsequent resale. Likewise, if the person taking the securities from the issuer does so with a view toward public distribution, the private financing transaction and the exemption therefor under Section 4(2) relied upon by the issuer may be lost.\textsuperscript{19}

\textit{The Numerical Test}

The exemption afforded by Section 4(2) of the Securities Act of 1933 was construed literally at first, but by graduations it was read more liberally until the decision of the Supreme Court in \textit{SEC v. Ralston Purina}\textsuperscript{20} in 1953. Prior to \textit{Ralston}, many securities practitioners relied solely upon the assumption that an offering to 25 persons or less did not constitute a public offering.\textsuperscript{21} The Supreme Court, however, rejected the numerical test as being exclusive, and in its place stated that the exemption must turn upon the knowledge of the offerees. The offerees must have a relationship with the issuer that gives them access to the same information that would be available in the form of a registration statement.\textsuperscript{22} Strictly interpreted, this test would void all private offering exemptions. The information

\textsuperscript{17} \textit{Id.} 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 or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but 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 distributors' or sellers' commission.

\textsuperscript{18} McClain v. Bules, 275 F.2d 431 (8th Cir. 1960); \textit{In re Eureka Co.}, 38 S.E.C. 475 (1958).

\textsuperscript{19} 346 U.S. 119 (1953).

\textsuperscript{20} In many cases, the stock in question is offered to a limited group of stockholders. The Securities Act, however, nowhere defines the scope of the private offering exemption. The only reference to a quantitative test is found in a statement by the House Committee that considered the Act: "Sales of stock to stockholders become subject to the Act unless the stockholders are so small in number that the sale to them does not constitute a public offering." H.R. REP. No. 152, 73d Cong., 1st Sess. 25 (1933). \textit{See also} SEC Securities Act Release No. 285 (January 24, 1935), which discusses factors to be considered in determining the availability of the exemption from registration.

\textsuperscript{21} Justice Clark stated: "Indeed nothing prevents the commission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims. But there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation." Ralston Purina, 346 U.S. at 125.

As far back as 1935, the Security and Exchange Commission's General Counsel stated that he "... regarded as significant the relationship between the issuer and the offerees. [A]n offering to the members of a class who should have special knowledge of the issuer is less likely to be a public offering than is an offering to the members of a class of the same size who do not have this advantage." 11 Fed. Reg. 10952 (1935).
available to a person due to his relationship with a company could never (in most cases) be as sufficient as the information made available to him had that company filed a registration statement. In commenting on this decision, one securities practitioner, a former policy maker with the Securities and Exchange Commission, stated:

I call these latter problems to your attention because anybody that has been through the registration process and has watched—and I say this advisedly, some of the fly specking of registration statements that goes on in the corporation finance division knows full well that no matter what information an issuer may supply to an investor, absent registration, it could not possibly be comparable to that which comes out of the registration process.22

The Investment Letter Technique

Since the rejection of the numbers test in Ralston Purina, a new procedure that assures the availability of the private offering exemption has become quite common. In order to assure that an individual has the proper motivations and intentions at the time of his purchase and will not distribute the securities to the public, each purchaser in a private sale transaction is required to agree to the following:

1. The execution of an investment letter which represents that the recipient of the securities will acquire them for investment and not with a view to distribution. Some investment letters further reflect that the purchaser is aware that the securities have not been registered under the Securities Act of 1933 and that if the purchase is for the account of other persons, the purchaser has sole investment discretion for the account of the persons for whom he is acting;23

2. The placing of a legend upon the face of the certificate restricting the transfer of the securities. Although the legend varies substantially from issue to issue, a typical legend would read:24

The shares represented by this certificate have not been registered under the Securities Act of 1933. The shares have been acquired for investment and not with a view to distribution and may not be pledged or hypothecated and may not be sold or transferred in the absence of an effective registration statement for the shares under the Securities Act of 1933 or an opinion of counsel for the company that registration is not required under said act.

24 Id. See also SEC v. Guild Films Co., 279 F.2d 485 (2nd Cir. 1960), for examples of restrictive legends.
3. The placing of a stop transfer notice with the issuer's transfer agent which prohibits the transfer of the shares bearing a restrictive legend.25

Although these criteria were designed to assure the availability of the exemption following the rejection of the numbers test in Ralston; the Crowell-Collier Publishing Company case26 held that:

The issuer may not establish claim to an exemption merely by collecting investment representations from a limited group of purchasers if, in fact, a distribution by such persons occurs. Counsel, issuers and underwriters who rely on investment representations as a basis for claim to nonpublic offering exemptions do so at their peril.27

Thus, not only has the securities practitioner been foreclosed from relying upon the pre-Ralston numerical test; Crowell-Collier has made the investment letter technique a risky basis for a claim. Also, the burden of proof is on the issuer to justify his claim under Section 4(2).28

The Holding Period and Change of Circumstances Doctrine

The result of the legal maneuverings by securities counsel and the Securities and Exchange Commission has also created uncertainty as to the length of the holding period necessary under an investment letter. The most frequently asked question both before and after private placements is, "How long must I hold?" The Crowell-Collier case recognized a two-year holding period as being presumptive of investment intent.29 The Commission has not always followed the two-year investment period, however, and has on occasion stated that a holding period of from three to five years would be necessary.30 Unfortunately, there can be no definitive answer to this question. It seems that the longer the period of retention, the more persuasive would be the argument that the original purchase was for investment purposes and without a view to distribution.

One exception to the long holding period requirement is the change of circumstances doctrine, recognized by the SEC,31 that gives

25 Id.
27 Id. at 7 (emphasis added).
29 Crowell-Collier, supra, note 26.
30 THE WHEAT REPORT at 165-6: "Members of the [SEC] Commission's staff have on occasion advised investors who hold privately placed debt securities that the staff would not look with disfavor on a resale after five years."

It has also been the experience of the author in requesting no action letters, that the Commission favors a 3-5 year holding period, depending upon the factual situation of each particular case.
affirmative relief to persons who have previously entered into investment covenants. The rationale of this doctrine is that although at the time of purchase the person may have contemplated a long term investment with no view to public distribution, certain intervening factors, unbeknown to him at the time and not preventable by him, now cause a change in his circumstances to the extent that it is necessary for the person to sell the securities. Although no clear criteria have developed as to what constitutes an adequate change of circumstances, the Commission has developed certain criteria as to what does not constitute a change of circumstances. For instance, it is fairly clear that a decline in the value of the stock taken is not such a change of circumstances as to allow relief. The theory of the Commission in finding such a change insufficient is that any person taking securities of any type must realize that the price may, and probably will, fluctuate in value. Any other change that could have reasonably been anticipated at the time of purchase is not considered to be of evidentiary value in establishing a change of circumstances. For example, a merger is an event reasonably to be anticipated in the life of a company and, accordingly, does not constitute a sufficient change of circumstances. It is also clear from rulings by the SEC that the substantiability of the required change of circumstances varies directly with the length of time between purchase and sale. The shorter the time, the more drastic the required change of circumstance. At the present time, the general criterion is that if a holding period of less than one year is involved, there must be a drastic change of circumstances. From one to two years, a major change of circumstances would be required. Beyond two years, a minimum change of circumstances would be indicative of relief.

THE WHEAT REPORT: RECOGNITION OF THE DILEMMA

In November, 1967, the Securities and Exchange Commission announced the formation of a small internal study group to examine the operation of the disclosure provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 and Commission Rules

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32 For example, the Commission stated that "... an advance or decline in market price or a change in the issuer's operating results are normal investment risks and do not usually provide an acceptable basis for such claim of changed circumstances. Possible inability of the purchaser to pay off loans incurred in connection with the purchase of the stock would ordinarily not be deemed an unforeseeable change of circumstances." SEC Securities Act Release No. 4552 (November 6, 1962), 27 Fed. Reg. 11316, 11317 (1962).

33 Crowell-Collier, supra, note 26.

34 The Wheat Report at 166, 167.

35 Id.

36 Id.
and Regulations promulgated thereunder. In the Spring of 1969 the study group published its report. Chapter Six of the Wheat Report was devoted to the study of secondary distributions and broker's transactions. After discussing the origin of the present practice of securing investment letters, the Wheat Report discussed the problems associated with the interpretation of "investment intent." In summary fashion, the study group concluded that the consequences were all detrimental to the administration of the securities laws, because of: (1) the existence of vague and imprecise standards; (2) an expanded workload for the Commission staff in responding to requests for interpretative advice and no action letters; (3) a lack of objective tests to determine when and how shares issued in a nonpublic transaction may be offered publicly, as this deficiency has provided an unfortunate leeway for the unscrupulous; and (4) the fact that even in flagrant cases of alleged violation of the registration requirements, the Commission's staff faces formidable problems of proof.

The Commission study group recommended that in seeking a solution to these problems, appropriate criteria should be kept in mind. These included: (1) the replacement of the present subjective tests associated with the statutory exemption, with tests as objective in character as possible and (2) an integration of the disclosure requirements under the 1933 and 1934 Acts with any new interpretations proposed. This would insure that new interpretations of the exemption provisions would be consistent with the fundamental aim of the legislation as expressed in the opening phrase of the 1933 Act: "To provide full and fair disclosure of the character of the securities sold in interstate and foreign commerce and through the mails and to prevent fraud in sale thereof."

88 See note 5, supra. The study was conducted under the direction of Commissioner Wheat, and has become known as the Wheat Report. It is an extremely comprehensive work, consisting of 397 pages plus lengthy appendices.
89 See discussion in text following note 22, supra.
40 THE WHEAT REPORT at 174. The standards relating to "change of circumstances" and the passage of "indeterminate amounts of time" have in the past operated to actually sanction the sale in interstate commerce of securities originally transferred in a nonpublic offering. As a result, many securities have been sold in interstate commerce without the availability of information concerning the issuers of the securities.
41 Id. at 175. Most of these requests concern the question, "when may I sell?" and deal with resales following a private offering. The authors of the report indicate that if a consistent, objective set of rules were in effect, approximately ninety per cent of such requests would be unnecessary.
42 "It has been the Commission's experience that unprincipled counsel will often give opinions on the availability of an exemption from registration when careful or responsible counsel would not do so." Id. at 177.
43 "An intent to distribute must be shown. All of the surrounding circumstances must be developed as bearing on the existence or lack of existence of such intent." Id.
44 Id. at 178.
The report then recommended that a new series of rules be proposed. The Commission study group recognized that the present test for claiming an exemption from registration is subjective and that the state of mind of the purchaser at the time of acquisition has absolutely no relevance to the question of disclosure of information to a subsequent purchaser. The Wheat Report suggests that a better approach to the problem would be a controlled distribution of common stock under a *dribbling rule* concept,\(^4\) provided that, (1) the issuer is currently filing information with the Securities and Exchange Commission so as to make information required for an investment decision available to the ultimate purchaser and (2) an adequate holding period has expired.\(^6\)

**Proposed Rule 160 Series: The Wheat Report Implemented**

In September of 1969 the Securities and Exchange Commission adopted the recommendations of the Wheat Report and proposed a set of new rules\(^4\) (referred to as the 160 series) that were designed to inhibit the creation of public markets and halt the transfer of securities of issuers which did not disclose information to the public and make appropriate filings with the Commission. At the same time, where issuers do make such filings, the proposed rules would have permitted public sale without registration in ordinary trading transactions of limited quantities of their securities by both control persons and persons who acquired the securities in private placements.\(^8\)

Since these proposed rules have subsequently been abandoned by the Securities and Exchange Commission, we will discuss them only briefly to set forth their principal provisions in order to contrast them with the now proposed Rule 144.

Proposed Rule 161 defined “restricted security” as follows: \(^4\)

A. Restricted security means any security acquired directly or indirectly from its issuer or from any person in a control relationship with its issuer in a transaction or a chain of

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\(^4\) A *dribbling rule* is essentially the placing of a quantity limitation upon the sale of securities. The *Wheat Report* study group stated that: “An appropriate quantity limitation will tend, at least, to diminish the temptation to stimulate the public’s appetite in advance of sale which may otherwise exist on the part of those who wish to dispose of a sizable percentage of a company’s outstanding stock. For quantities in excess of the limitation, the requirement of registration will cause the available factual information about the company to be weighed and measured with care.” *Id.* at 192.

\(^6\) *Id.* at 152, 153.

transactions, none of which was a public offering or other public disposition.

B. If a restricted security has been such for any period of five consecutive years, during each of which its issuer has had annual gross revenues from operations amounting to at least $250,000, it shall cease to be a restricted security.

The effect of Rule 161 was to prevent public distribution of the restricted securities without a registration statement until such time as the company had attained a certain financial stability. Until the occurrence of such an event, the securities could not be sold to the public without a registration statement regardless of the length of time they had been held.

Under proposed Rule 163, restricted securities which were subject to the reporting requirements of Section 12(b), (g) or Section 15(d) of the Securities Exchange Act of 1934 were eligible for listing as qualified securities. The sale of securities of issuers complying with these 1934 Act reporting requirements were eligible for exemption from the definition of distribution pursuant to Proposed Rule 162.

Rule 162 defined distribution as any public offering of a security unless specified requirements are met. In addition, it permitted the resale of Rule 163 securities after a one-year holding period, provided that not more than one per cent of the outstanding securities were sold during any six months and the securities were sold through a broker acting as agent for the seller. Thus, the effect of the Rule 160 Series was to provide a one-year holding period for securities of companies which were filing current reports under the Securities Exchange Act of 1934 and to impose at least a five-year holding period for companies which were not filing current reports. The rules as proposed would have replaced the present provisions of Rule 154 allowing insiders to sell under the dribble formula of the rule.

PROPOSED RULE 144: RETREAT TO CONFUSION AND UNCERTAINTY

Even though the securities industry and securities bar had generally looked with favor upon the proposed Rule 160 Series, the
SEC was not happy with them. In September, 1970, one year after the 160 Series proposal, the SEC proposed the adoption of Rule 144.\footnote{PROPOSED RULE 144(a).}

Generally, the proposed Rule 144 relates to the definition of the term "underwriter" in Section 4(4) of the Securities Act of 1933, and proposes to repeal Rules 154 and 155 under said Act.

More specifically, the Rule provides that any affiliate of an issuer or any other person who has acquired securities directly or indirectly from the issuer in a transaction not involving any public offering may offer or sell securities of such issuer and be presumed not to be an underwriter of the securities, or to be engaged in the distribution thereof within the meaning of Section 2(11) of the Act, provided that the following conditions are met.\footnote{PROPOSED RULE 144(a)(1).}

1. \textit{The Holding Period}\footnote{Id. 144(a)(1).}

The person making any offer shall have owned and paid the full purchase price of the securities for at least 18 months prior to the offering.\footnote{Id. 144(a)(1)(A).} The Commission's staff has previously applied the fungibility rule to securities purchased at different times in considering requests for \textit{no action} letters. The fungibility rule is stated for the first time in the Rule and is retained in part.\footnote{Id. 144(a)(1)(C).} It provides that any person making an offering pursuant to Rule 144 shall not have agreed to acquire, directly or indirectly, from the issuer or from an affiliate of the issuer during such 18-month period, in a transaction not involving any public offering, any other securities of the same class as those being offered. Securities acquired from the issuer through a dividend, stock split or recapitalization are deemed to have been acquired at the same time as the securities upon which the action was based.\footnote{Id. 144(a)(1)(D)(i).} If the securities were exchanged with the same issuer on a conversion or exercise of warrants, then the securities offered are deemed to have been acquired at the same time as the securities surrendered.\footnote{Id. 144(a)(1)(D)(ii).} Finally, if the securities are offered on be-
half of the estate of a deceased person who was not an affiliate of the issuer, the holding period provisions of the rule are not applicable.62

2. Limitation on Amount of Securities63

Rule 144 adopts the dribble rule provisions of Rule 154 with certain extensive modifications.64 The Rule 144 proposal requires that the amount of securities involved in the transaction, together with all other sales of securities of the same class within the preceding 12 months, by or on behalf of the person and his associates shall not exceed (1) approximately one per cent of the shares or units of such security outstanding at the time of receipt by the broker of the order to execute such transactions if the security is traded only otherwise than on a securities exchange or (2) the lesser of (A) approximately one per cent of the shares or units of such securities outstanding at the time of receipt by the broker of the order to execute such transaction or (B) the largest aggregate reported volume of trading on securities exchanges during any one week within the four calendar weeks preceding the receipt of such letter, if the security is admitted to trading on a securities exchange.

The aggregate amount of securities of the issuer which may be sold under this rule during any period of 12 months by all directors, officers and affiliates of the issuer and their associates, shall not exceed twice the maximum amount permitted in the preceding paragraph.

3. Current Public Information65

The proposed Rule also provides that current financial and other information concerning the issuer must be made available to the public. The Commission, citing SEC v. Ralston Purina,66 stated that because the purpose of the Act is to provide full and fair disclosure to public investors, considerations similar to those given Section 4(2) (availability of information) also apply in determining whether an exemption under Section 4(1) is available, since the persons to be

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62 Id. 144(a)(1)(D)(iii).
63 Id. 144(a)(2).
64 Briefly, the dribble rule provision of Rule 154 limits the sale of securities of the same class by or on behalf of the person, to one per cent of the shares or units outstanding during a six month period. Substantial revision of this limitation was undertaken by PROPOSED RULE 144. Generally, the new proposal would double the limited sale period (from six months to 12 months) and require that the person and his associates have not sold over one per cent of the outstanding shares or units of securities of the same class during this 12-month period.
65 PROPOSED RULE 144(a)(3).
protected are the same whether the sale is by an underwriter or an issuer. There is a presumption under the proposed rule that the required information is available with respect to an issuer which is required to and does file reports pursuant to Section \(13^{67}\) or \(15(d)^{68}\) of the Securities Exchange Act of 1934. With respect to other issuers, the seller of the securities and the brokers involved in the transaction will have the obligation of determining whether adequate current information is publicly available. According to the Commission, factors that should be considered in making such a determination include whether a reasonably current balance sheet and a profit and loss statement, and current material information about the issuer's business and management have been published or furnished to security holders.

4. Manner of Offering\(^69\)

The securities may be sold only in unsolicited broker's transactions. The person selling in such a broker's transaction must disclose to the broker any material nonpublic information about the issuer which he has. The offering must be made through a broker acting as agent for the person. The broker must act in an ordinary brokerage transaction, the limits of which are spelled out in subparagraph 4(B) of proposed Rule 144. The broker may enter into the transaction only if, after reasonable inquiry has been made, he is not aware of circumstances indicating that his principal is an underwriter with respect to the securities or that the transaction is part of a distribution of securities on behalf of his principal.\(^70\)

Some of the Consequences of Adoption

Should proposed Rule 144 be adopted, the staff of the Commission will not thereafter issue no action letters with respect to matters covered by the provisions of the Rule\(^71\) and the burden will be on the sellers of securities to ascertain that an exemption is available.\(^72\) Furthermore, the staff will no longer issue either no action or interpretative letters with respect to changes in circumstances which might warrant the sale of securities sooner than the Rule provides.\(^73\) If a person is to rely upon a change in circumstances other than death, he must sustain the burden of showing that such a change is legally sufficient to justify the sale of the securities.

\(^{68}\) Id. § 78o(d) (Supp. 1970).
\(^{69}\) PROPOSED RULE 144(a)(4).
\(^{70}\) See Appendix.
\(^{72}\) Id.
\(^{73}\) Id.
If the proposal is adopted, Rules 154 and 155 would no longer be necessary and would be rescinded, since proposed Rule 144 is essentially a revision of Rules 154 and 155.

**DEFICIENCIES OF RULE 144**

Rule 144 fails in its attempt to bring certainty to the field of restricted stock, and in addition severely limits sales by persons in a control relationship with the issuer.

The Rule does not purport to rescind or change the existing state of the law in regard to either investment or change of circumstances. Instead, it presents a new test for the sales of shares under certain conditions. Unfortunately, the Rule does not provide a clear exemption; it merely creates a presumption\(^4\) that there is no underwriter involved in the transaction. Since the Rule does not define the nature of this presumption, the cautious practitioner must assume that a rebuttable presumption is intended. In the event a rebuttable presumption is intended, the person selling pursuant to the Rule is faced with the task of determining that all provisions are complied with. This task will be onerous due to the ambiguous language involved, and the person selling pursuant to the Rule will assume the risk of the transaction. Alternatively, a stated purpose of the Wheat Report proposals and the Rule 160 Series proposals was a desire to implement greater certainty with respect to the exemptions from registration applicable to investment securities.

**The Change of Circumstances Quandary**

Although Rule 144 does not discuss the change of circumstances doctrine, the securities release announcing the proposed Rule does discuss the doctrine\(^5\) but also indicates that the Commission staff will discontinue the issuance of no action letters with respect to matters covered by the provisions of the Rule.\(^7\) This results in a burden being placed on the sellers of securities to ascertain that an exemption is available because of a change of circumstances. Far more desirable are the provisions stated in the Rule 160 Series which did not provide for exceptions due to a change of circumstances, but did allow a shortened period of holding. By recognizing change of circumstances while refusing to issue no action letters, the Commission has compounded the confusion that is already present under existing law.

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\(^4\) **PROPOSED RULE 144(a).**


\(^7\) *Id.*
Reporting Requirements

The reporting requirements under Rule 144 have been extended from the original provisions of the Rule 160 Series to include, in addition to companies already filing periodic reports with the Securities and Exchange Commission, a provision for inclusion of securities of other issuers who have published or furnished to securities holders certain types of financial information. The rule speaks in terms of a presumption that the requirements have been satisfied if the issuer publishes such information. Again, the seller of securities and the broker must assume the burden of determining whether adequate information has been published. Although in the case of control persons the seller may have information which would indicate to him whether or not the company had filed adequate financial reports, the proposed Rule places the noncontrol person who is attempting to sell pursuant to the Rule at a disadvantage. The fact that the requirements will be presumed to be satisfied is not an adequate safeguard for the noncontrolling person selling pursuant to the Rule. If the Commission is of the opinion that the presumptive tests must remain, then it would appear more reasonable to return to the public information standards required under the Rule 160 Series. In such instances pressure from purchasers of unregistered securities prior to the issuance would force the company to become a reporting company under the 1934 Act at the risk of losing the sale to the prospective purchaser. The Commission stated that they rejected the Rule 160 Series in part because it adversely affected the ability of small corporations to raise capital essential to their growth. It is pointed out, however, that any company, regardless of size, may voluntarily become a reporting company under Section 12(g) of the Securities Exchange Act. The reporting requirements are burdensome but are not so onerous as to prevent voluntary compliance.

Holding Period Requirements

The holding period requirements under the Rule present substantial and seemingly unwarranted restrictions, especially with regard to those persons in a control position. All of these provisions are extremely harsh and are contrary to the detailed study made by the Commission study group in the Wheat Report. Whereas Rule 154 allowed a person in a control position to sell securities purchased in the public market at any time, Rule 144 apparently imposes an 18-month holding period on any securities purchased by a person in

77 Proposed Rule 144(a)(3).
78 Id.
80 See note 51, supra.
a control position. The imposition of an 18-month holding period on control persons is unprecedented. We can only assume that the Commission in drafting this portion of the Rule failed to specify that the provision would apply only to shares taken in a private placement of securities.

A second unprecedented restriction arises after the control person has held his stock for an 18-month period. Following this period, the control person (or any person buying in an unregistered transaction) may sell up to one per cent of the company's stock (or permissible volume limit) within a 12-month period. The 12-month period for disposing of one per cent of the company's stock constitutes a doubling of the time permitted under Rule 154, so that the effective distribution by a control person is cut in half. In issuing interpretative opinions, the Securities and Exchange Commission has previously taken the position that Rule 154 could not be used by a control person in successive six month periods. The provision as written, however, when read in conjunction with the other provisions of Rule 144 which impose an aggregate limit on the shares that can be sold by all directors, officers and affiliates of the issuers and their associates, constitutes a severe restraint on sales by the persons in the control group.

In addition, controlling persons may have to reduce the number of shares they may sell because of sales by other persons in the control group. This situation is essentially a consequence of the Commission's inclusion of the clause "all associates of such person" in the provision of the Rule. Consequently, prior to making any sale, any officer, director or affiliate of the issuer or their associates will be forced to determine the number of shares that have been sold in the preceding 12 months by all other persons in the group. It is conceivable that in many companies, inquiry would be required of numerous individuals who may be located in different parts of the country and even on other continents. The larger the corporation the more extensive is this burden of determining the availability of Rule 144. Strict adherence is required due to the fact that the sale is only presumptively valid. A natural result of this type of restriction will be inequities in selling procedures among the control group. Members of the group may be forced to sell securities early within the period in order to avoid being precluded from selling at a later date by other

81 PROPOSED RULE 144(a)(1)(A).
82 Id. 144(a)(2)(A).
83 SEC Securities Act Release No. 4818 (January 21, 1966). Apparently, the Commission feels that the selling of securities in successive six month periods is not "routine trading" and therefore, it amounts to a distribution which does not qualify for an exemption.
84 PROPOSED RULE 144(a)(2)(A).
members of the group. And from an enforcement standpoint, the provision is virtually impossible to police since no standards are given for identifying the group or keeping track of sales within the group.

Furthermore, the proposed Rule does not indicate whether it will be applied prospectively or retroactively. Legitimate inquiry may be made as to the applicability of the Rule in a number of circumstances. Illustrative of the type of question raised is whether a holder of restricted stock, otherwise entitled to sell pursuant to Rule 144, is precluded therefrom by the acquisition of additional stock of the same class immediately prior to the proposal or adoption of the Rule. Under the provisions of Rule 144(a)(1)(C), an individual could not qualify for the exemption if the Rule were applied retroactively. This example is indicative of the many questions encountered in connection with the Commission’s failure to state the applicability of the Rule.

CONCLUSION

The holder of restricted stock under Rule 144 is forced to rely on essentially the same subjective criteria as are present in the existing law that developed under Rules 154 and 155, and the Ralston Purina case. The securities practitioner is in need of some objective criteria which will clarify the many ambiguous and confusing areas existing under the present law and proposed Rule 144.

A far better approach to the problem was contained in the Wheat Report and the Rule 160 Series previously proposed. Therefore, a revision of the Rule 160 Series, to meet the objections raised by the Securities and Exchange Commission, would be a more promising approach to settlement of the existing dilemma.

APPENDIX

Securities Act Release No. 5087
(September 22, 1970)

[Proposed] Rule 144. Persons Presumed Not To Be Underwriters

Note: For the purposes of this rule the definitions of the terms “affiliate” and “associate” in Rule 405 under the Act and of “person” in Section 2(2) of the Act shall apply.

(a) Any affiliate of an issuer who offers or sells securities of such issuer which the affiliate has acquired directly or indirectly from such issuer or otherwise, or any other person who offers or sells securities of an issuer which such person has acquired directly or indirectly from such issuer or from an affiliate of such issuer in a transaction not involving any public offering, shall be pre-
sumed not to be an underwriter of such securities and not to be engaged in a
distribution thereof within the meaning of Section 2(11) of the Act if all of
the following conditions are met:

(1) **Holding Period.**

(A) The person making the offering has owned the securities for a
period of at least 18 months prior to the offering.

(B) The full purchase price or other consideration for the securities
was paid or given at least 18 months prior to the offering.

(C) During such 18 months the person making the offering has not
acquired or agreed to acquire directly or indirectly from the issuer or
from an affiliate of the issuer, in a transaction not involving any public
offering, any other securities of the same class as those offered, any secu-
rities convertible into securities of such class, or any options, warrants or
rights to purchase securities of such class.

(D) For the purpose of this part (1), (i) securities acquired directly
from the issuer by reason of a dividend, stock split or recapitalization shall
be deemed to have been acquired at the same time as the securities on
which the dividend was paid, the securities which were split or the securities
surrendered in connection with the recapitalization; (ii) where the person
acquired the securities directly from the issuer for a consideration con-
sisting solely of other securities of the same issuer surrendered for con-
version, or through the exercise of warrants by the surrender of debt
securities so acquired, the securities offered shall be deemed to have been
acquired at the same time as the securities surrendered for conversion or
upon the exercise of the warrants; and (iii) if the securities are offered
on behalf of the estate of a deceased person who was not an affiliate of the
issuer, the provisions of this part (1) shall not apply.

(2) **Limitation on Amount of Securities.**

(A) The amount of securities involved in the transaction or trans-
actions, together with all other sales of securities of the same class within
the preceding 12 months by or on behalf of the person and all associates
of such person shall not exceed the following:

(i) if the security is traded only otherwise than on a securities ex-
change, approximately 1% of the shares or units of such security
outstanding at the time of receipt by the broker of the order to ex-
cute such transactions; or (ii) if the security is admitted to trading on
a securities exchange the lesser of approximately 1% of the shares or
units of such security outstanding at the time of receipt by the broker
of the order to execute such transactions or the largest aggregate re-
ported volume of trading on securities exchanges during any one week
within the four calendar weeks preceding the receipt of such letter.

(B) Notwithstanding paragraph (A), the aggregate amount of secu-
rities of the issuer which may be sold under this rule during any period of
12 months by all directors, officers and affiliates of the issuer and their
associates shall not exceed twice the maximum amount permitted by para-
graph (A) above.
(3) **Current Public Information.**

There is publicly available reasonably current and informative information about the financial condition, results of operations, business and management of the issuer of the securities. This requirement will be presumed to be satisfied if the issuer is required to file and does file reports with the Commission pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. If the issuer is not required to file such reports, this requirement will be presumed to be satisfied if the issuer has published or furnished to security holders (A) financial statements including a balance sheet as of a date within 12 months prior to the offering, a profit and loss statement for a period of at least 12 months prior to the date of the balance sheet and, if such balance sheet is not as of a date within six months prior to the offering, an additional profit and loss statement for the period from the date of the balance sheet to a date within six months prior to the offering, all prepared in accordance with generally accepted accounting principles and practices and certified by a public accountant or attested to by the chief financial or accounting officer of the issuer, and (B) material information as of a date within 12 months in regard to the issuer's business management, unless there has been a material change in the information, in which case more recent information has been published or furnished to security holder.

(4) **Manner of Offering.**

(A) The person making the offering does not (i) solicit or arrange for the solicitation of orders to buy the securities in anticipation of or in connection with the transaction; (ii) make any payment in connection with the execution of the transaction to any person other than the broker who executes the order; and (iii) have any material non-public information about the issuer which he has not disclosed to the broker.

(B) The offering is made through a broker acting as agent for the person and the broker (i) 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; (ii) neither solicits nor arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction, provided that the foregoing shall not preclude inquiries by the broker of other brokers or dealers as to their interest in the securities, or the publication by the broker of bid and offer quotations for the securities in an inter-dealer quotation service; and (iii) the broker after reasonable inquiry is not aware of circumstances indicating that his principal is an underwriter with respect to the securities or that the transaction is a part of a distribution of securities on behalf of his principal.*

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* Reasonable inquiry in this context should include inquiry as to the following:
  1. The length of time the seller has held the securities (if practicable the inquiry should include physical inspection of the securities);
  2. Sales of securities by the seller and his associates in the past twelve months;
  3. Whether the seller and his associates intend to sell securities of the same class through any other means;
  4. Whether the seller is an officer, director, or affiliate of the issuer, and if so, the total sales by such persons and their associates in the past twelve months;
(b) The term “brokers’ transactions” in Section 4(4) of the Act shall be deemed to include transactions by a broker acting as agent for the account of a person who offers or sells securities pursuant to the provisions of this rule.

5. Whether the seller has solicited or made any arrangements for the solicitation of buy orders in connection with the proposed transaction;
6. Whether the seller has made any payment to any other person in connection with the transaction;
7. The number of shares of the class outstanding or the relevant trading volume;
8. Whether there is current information concerning the issuer publicly available; and
9. Whether the seller has knowledge of any non-public material information about the issuer.

* * * * *

All interested persons are invited to submit their views and comments on the proposed rule, in writing, to Orval L. DuBois, Secretary, Securities and Exchange Commission, Washington, D.C. 20549, on or before October 30, 1970. All such communications will be considered available for public inspection.

By the Commission.

Orval L. DuBois
Secretary