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# THE SECURITIES ACTS AMENDMENTS OF 1964: BACKGROUND, EFFECT AND PRACTICALITIES\*

by  
James C. Sargent\*\*

THE Securities Acts Amendments of 1964 present many obligations and problems never before faced by over-the-counter companies, their officers, directors, and stockholders where such companies have total assets in excess of \$1,000,000 and a class of equity securities held of record by 500 or more persons.<sup>1</sup> Attorneys who have been providing corporate advice to medium-sized companies are now faced with the task of educating their clients as to reporting requirements, proxy rules, insider reporting and trading restrictions and liberal concepts of fraud. This Article is intended to serve as a guide to the practitioner in the field.

## I. PROLOGUE

Before discussing the effect which these 1964 amendments have upon unlisted companies meeting the test of \$1,000,000 total assets and 500 shareholders, we should look at the legislative history and other events which preceded their enactment. Such history and events may lend valuable assistance in determining congressional intent underlying the amendments.

As long ago as 1946, the Securities and Exchange Commission (SEC) reported to Congress<sup>2</sup> its proposal that all corporate issuers having \$3,000,000 or more in assets and 300 or more shareholders should be subjected to (1) the registration requirements of section 12 of the Securities Exchange Act of 1934;<sup>3</sup> (2) the filing of annual, semi-annual and periodic reports required by section 13;<sup>4</sup> (3) compliance with section 14, the proxy statute, and rule 14, the SEC proxy rule promulgated thereunder;<sup>5</sup> and (4) the requirement that all offi-

\* The author acknowledges the assistance of his associate, Michael Heitner, a member of the New York Bar, in the preparation of this Article. The opinions expressed are those of the author and should not be interpreted as the views of the Securities and Exchange Commission.

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<sup>1</sup> 15 U.S.C. § 78l(g)(1) (1964).

<sup>2</sup> On June 19, 1946, the SEC forwarded to Congress its report and recommendation that § 12 of the Securities Exchange Act be amended to include the "larger unregistered corporations so as to give to investors the benefits of financial reporting, proxy solicitation and protection against trading by corporate insiders." The report listed detailed abuses in unregistered securities and was introduced as proposed legislation. See SEC, *Proposal to Safeguard Investors in Unregistered Securities*, H.R. Doc. No. 672, 79th Cong., 2d Sess. 31-32 (1946).

<sup>3</sup> 15 U.S.C. § 78l (1964)

<sup>4</sup> 15 U.S.C. § 78m (1964).

<sup>5</sup> 15 U.S.C. § 78n (1964); 17 C.F.R. § 240.14A (1964).

cers, directors and ten per cent shareholders of such company file insider ownership reports under section 16(a) and be subject to the disgorgement of profits provision of section 16(b) on any short swing profits made by them.<sup>6</sup>

This SEC proposal<sup>7</sup> for broader applicability of the above requirements was subsequently embodied in the Frear Bill.<sup>8</sup> Although the bill as later amended was supported by the President, the New York and American Stock Exchanges, the Investment Bankers Association, and the National Association of Securities Dealers,<sup>9</sup> the legislation was never enacted into law. The commencement of the Korean War undoubtedly involved Congress in more urgent legislative proposals.<sup>10</sup>

In early 1955, Senator Fulbright undertook to commence his now famous "friendly" study of the Stock Market,<sup>11</sup> a study which inevitably resulted in the first Fulbright Bill.<sup>12</sup> In the first instance, this proposed legislation sought to make sections 12, 13, 14 and 16 of the Securities Exchange Act of 1934 applicable to companies with \$5,000,000 of assets and 500 shareholders.<sup>13</sup> In the second Fulbright Bill these figures were increased to \$10,000,000 and 1,000 share-

<sup>6</sup> 15 U.S.C. § 78p(a), 1(b). See also SEC, *Report of Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 3, p. 1 (1963).

<sup>7</sup> Since the Securities Exchange Act of 1934 became law, all these requirements have, of course, been applicable to companies with securities registered on a national securities exchange.

<sup>8</sup> Senator J. Allen Frear, Jr. of Delaware, Chairman of the Securities and Exchange Commission Subcommittee of the Banking and Currency Committee, introduced into the Senate on August 8, 1949, S. 2408, 81st Cong., 2d Sess., which applied to companies with \$3,000,000 or more of assets and 300 or more shareholders. See *Hearings Before the Subcommittee of the Senate Banking and Currency Committee on S. 2408*, 81st Cong., 2d Sess. (1950); see the testimony of SEC Chairman McDonald, *id.* at 3-6 and by Loss, *id.* at 7-44 wherein it was stated, among other things, that "In one case that came to our attention the form of the proxy appeared on the back of the dividend check, so that if you endorsed your check you gave a proxy, unless you said 'I don't want this to be a proxy.'" See 2 Loss, *SECURITIES REGULATION* 1151-56 (1961).

<sup>9</sup> *Id.* at 1156.

<sup>10</sup> *Id.* at 1158.

<sup>11</sup> See Senate's Banking and Currency Committee, *Staff Report on Factors Affecting the Stock Market*, S. REP. No. 376, 84th Cong., 1st Sess. 9 (1955), introduced at the conclusion of the Senate Banking and Currency Committee's *Stock Market Report* on May 26, 1955. See 2 Loss, *op. cit. supra* note 8, at 1158.

<sup>12</sup> On May 24, 1955, Senator J. W. Fulbright of Arkansas, then Chairman of the Banking and Currency Committee of the Senate, introduced S. 2054 (84th Cong., 1st Sess.), a bill to extend the registration, reporting, proxy and insider trading provisions of §§ 12, 13, 14 and 16 of the Securities Exchange Act to additional medium-size corporations and their officers, directors and 10% stock owners. This Fulbright bill was almost identical with the earlier introduced Frear bill, but its standards applied only to companies with \$5,000,000 of assets or more and 500 shareholders or more. The standards, after the SEC comments, were changed to \$2,000,000 of assets plus a provision for deregistration if the assets fell below \$1,000,000. S. 2054, 84th Cong., 1st Sess. (Comm. Print, July 26, 1955).

<sup>13</sup> A bill identical to the first Fulbright bill before its amendment was introduced into the House as H.R. 7845, 84th Cong., 1st Sess. by Representative Arthur G. Klein of New York, then Chairman of the Subcommittee on Securities of the Interstate and Foreign Commerce Committee of the House. No final action was taken on S. 2054 or H.R. 7845 by either the Senate or the House.

holders.<sup>14</sup> The amended bill was reported out of the Senate Banking and Currency Committee and was passed by the Senate,<sup>15</sup> but it was never reported out of the House Interstate and Foreign Commerce Committee (probably due to the opposition of its chairman, Oren Harris).

In late 1960, the SEC investigation, revocation proceedings and subsequent criminal indictment of the American Stock Exchange specialist firm of Re, Re & Sagarese and its partners, charging specialist activities which had defrauded public securities holders out of millions of dollars became a matter of public knowledge. This event was followed by the SEC investigation of the American Stock Exchange and the subsequent resignation from that Exchange of its president, chairman of the board, and general counsel.<sup>16</sup> The Subcommittee on Commerce and Finance of the House Interstate and Foreign Commerce Committee became interested.<sup>17</sup> After considering whether the existing federal securities statutes, particularly the Securities Exchange Act of 1934, provided adequate protection for public investors, the Subcommittee recommended<sup>18</sup> to the full Committee that a study be undertaken to determine whether any new legislation was needed and, if not, whether modification or expansion of existing rules or securities laws was necessary in the public interest.<sup>19</sup> The Committee approved this recommendation, and Congress, in September of 1961, added a new section 19(d) to the Exchange Act which provided in substance that the SEC be given \$750,000, which was appropriated by the Congress, to conduct what is now commonly referred to as the Special Study of Securities Markets.<sup>20</sup>

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<sup>14</sup> In the 85th Cong., 1st Sess. (1957) Senator Fulbright, still the Chairman of the Senate's Banking and Currency Committee, introduced S. 1168 which was almost identical with S. 2054 which he had introduced into the 84th Cong. This "new" Fulbright bill was in July 1957 unanimously reported out as amended by the Subcommittee on Securities to the full committee. The amendments, among other things, reduced its application to companies having \$10,000,000 of assets and 1,000 shareholders. The bill was passed by the Senate. (See S. REP. No. 700, dated July 24, 1957.) The House took no action on this matter.

<sup>15</sup> *Ibid.*

<sup>16</sup> See SEC DIVISION OF TRADING AND EXCHANGES (now the Division of Trading and Markets) CONCERNING THE AMERICAN STOCK EXCHANGE, *Special Study of the Securities Markets*, ch. XII-C (1962). See SEC Securities Exchange Act Release No. 6699, Jan. 6, 1962. H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 3, at 1 (1963); Re, Re & Sagarese, SEC Securities Exchange Act Release No. 6264 (1960); see also *United States v. Re*, 336 F.2d 306 (2d Cir. 1964).

<sup>17</sup> *Ibid.* See *United States Code Congressional and Administrative News*, Vol. 2, 87th Cong., 1st Sess., 1961, at 2557.

<sup>18</sup> See notes 16, 17 *supra*.

<sup>19</sup> See notes 16-18 *supra*.

<sup>20</sup> 15 U.S.C. § 78s(d); H. J. Res. 438, to accompany H.R. No. 882, August 10, 1961, Pub. L. No. 87-196, 87th Cong., 1st Sess., 75 Stat. 465, Sept. 5, 1961. This statute was amended by 76 Stat. 247, 88th Cong., July 27, 1962 to extend the date when the *Special Study* report should be submitted to the Interstate and Foreign Commerce Committee from January 3, 1963 to April 3, 1963, and increased the total amount appropriated for the study

The monumental *Special Study*,<sup>21</sup> which was two full years in the making,<sup>22</sup> made 175 specific recommendations as to matters where regulatory controls were found to be deficient.<sup>23</sup> While most of the problems could apparently be solved through the SEC rule-making power, the Commission subsequently did formulate specific legislative proposals to carry out thirty-three of the recommendations of the *Special Study*. These proposals were embodied in H.R. 6793 which ultimately became the Securities Acts Amendments of 1964.<sup>24</sup>

While this legislation was pending and hearings were going on, two events of great significance and effect upon the capital markets occurred. The first was the DeAngelis vegetable oil scandal which resulted in the suspension of Ira Haupt & Co. from the New York Stock Exchange due to insolvency which occurred when the soy bean market collapsed and the banks' call for additional margin could not be met.<sup>25</sup> The second momentous event was the assassination of President Kennedy on November 22, 1963, and the drastic fluctuations of the exchange market prices on that afternoon and at the opening the following day.<sup>26</sup> These historical events afforded the impetus for enactment of the SEC's proposed legislation, signed into law by President Johnson, on August 20, 1964.

## II. SECURITIES ACTS AMENDMENTS OF 1964—EXPANDED COVERAGE

The 1964 Amendments essentially had two purposes: (1) "to ex-

from \$750,000 to \$950,000. *Report of Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 3, at 1 (1963).

<sup>21</sup> See remarks of Senator Willis Robertson, Chairman of the Senate Committee on Banking and Currency, on the floor of the Senate, where the legislation authorizing the *Special Study* was declared to be the most significant securities legislation in over twenty years. 110 CONG. REC. 17799 (1964).

<sup>22</sup> It contains thirteen chapters, printed in four parts, with a fifth being a summary of first four parts, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

<sup>23</sup> Note 20 *supra*.

<sup>24</sup> H.R. 6789, H.R. 6793, and S. 1642, 88th Cong., 2d Sess. signed into law by the President on August 20, 1964, Pub. L. No. 88-467 (1964). See also S. REP. (Banking and Currency Committee) No. 379, July 24, 1963 (to accompany S. 1642) and H.R. (Interstate and Foreign Commerce Committee) No. 1418, May 19, 1964 (to accompany H.R. 6793); 109 CONG. REC. (1963); 110 CONG. REC. (1964); *United States Code Congressional and Administrative News*, vol. 2, 88th Cong., 2d Sess. 1964, at 3013.

<sup>25</sup> It was the voluntary petition of bankruptcy filed by Allied Crude (Vegetable Oil and Refining Company of Bayonne, New Jersey) in United States District Court in Newark that caused the two securities houses it had trades with—J. R. Williston & Beame, Inc. and Ira Haupt & Co.—to be suspended by the New York Stock Exchange Wednesday.

Prices on the New York Stock Exchange dropped sharply yesterday, triggered apparently by investors' reaction to the brokerage house suspensions.

Anthony De Angelis is the President of Allied Crude.

New York Times, Nov. 22, 1963, p. 1, col. 4.

<sup>26</sup> "The sharp drop in all prices that took place on the New York Stock Exchange on Friday (November 23, 1963) gives some substance to the view [that the economy would suffer as a result of President Kennedy's assassination on November 22, 1963]." New York Times, Nov. 24, 1963, § 3, p. F, col. 7.

tend disclosure requirements to the issuers of additional publicly traded securities" and (2) "to provide for improved qualification and disciplinary procedures for registered brokers and dealers."<sup>27</sup> The scope of this article is confined to the first of these two basic purposes.

An obvious result of these amendments was to remove the artificial and illogical distinction between the applicability of the disclosure requirements of section 12, 13, 14 and 16 of the Securities Exchange Act to listed companies and their officers, directors and ten per cent shareholders and the complete absence of any such requirement for many unlisted companies which had never filed a Securities Act registration statement. Some of these latter companies, financially quite substantial, would provide practically no information to their own stockholders or to the public at large.<sup>28</sup> To be sure, the original section 15(d) of the Securities Exchange Act, which had been adopted in 1936, had resulted in the successful extension of disclosure requirements through the filing of annual, semi-annual and periodic reports with the SEC pursuant to section 13 of the Exchange Act.<sup>29</sup> Section 15(d), before its amendment in 1964, required all companies filing Securities Act registration statements to file the reports required by section 13 if the value of the securities registered, computed at the public offering price, exceeded \$2,000,000. If the value of all outstanding securities computed at the public offering price fell below \$1,000,000, the obligation to make such filing was automatically suspended.<sup>30</sup>

The 1964 amendments modified section 15(d) to provide that the obligation to file would be automatically suspended after the fiscal year in which the registration statement became effective, if, at the beginning of any subsequent fiscal year, the securities of each class so registered were held of record by less than 300 persons.<sup>31</sup> Thus,

<sup>27</sup> See title to Pub. L. No. 88-467.

<sup>28</sup> See 2 Loss, *op. cit. supra* note 8, at 1154-55 and REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, *op. cit. supra* note 20, at ch. IX.

<sup>29</sup> SEC, *Report on Trading of Unlisted Securities Upon National Securities Exchanges*, S. REP. NO. 1739, at 3 and H.R. REP. NO. 2601, at 4, 74th Cong., 2d Sess. 1936. The section was adopted by the Congress along with other amendments offered in the second session of the 74th Congress (1936).

<sup>30</sup> 15 U.S.C. § 780(d) prior to August 20, 1964 amendment thereto.

<sup>31</sup> 15 U.S.C. § 780(d) (1964), as amended. The commission, in its ultimate determination, has provided for a somewhat different standard for compliance with §§ 12, 13, 14 and 16 of the Securities Exchange Act for companies and their officers where such companies had either previously become registered under § 12(g) or had filed registration statements under the Securities Act, from those required for initial registration under § 12(g). Thus, a company which had previously filed a registration statement under the Securities Act or had become registered under § 12(g) could become deregistered, if it could show that its total number of shareholders was less than 300. In the case of a company which had not previously filed a registration statement under the Securities Act or had become registered under the Securities Exchange Act, such company would only have to file under § 12(g) and thereby become subject to §§ 12, 13, 14 and 16 if after July 1, 1966, it had 500

companies having filed 1933 act registration statements are still subject to section 15 (d) and will continue to file pursuant to section 13 if they have more than 300 shareholders. However, unless such companies are required to register under section 12 (g), they will not be obligated to comply with the proxy rules adopted under section 14; nor will their officers, directors and ten per cent stockholders be subject to the insider reporting and restrictive short swing trading provisions of section 16.

In any event, the staff conducting the *Special Study* took a hard look at this problem and determined that a company with 300 shareholders had a sufficiently significant public investor interest to warrant the filing of the reports required by section 13 of the Exchange Act.<sup>32</sup> The *Special Study*, however, rejected a minimum total asset test which had been a requirement of earlier bills.<sup>33</sup> The *Study* concluded, quite logically, that investors in weak companies or in companies small in size or having a small or modest dollar value of assets probably were as much or even more in need of the protections disclosure would afford as were investors in larger companies or companies where the dollar value of assets was more substantial.<sup>34</sup> Also, the *Study* group seemed to feel that an asset test was inappropriate because the assets and earning power relationship varied so greatly in different industries and because some companies with large investor interest, such as service companies, seemed to have limited assets.<sup>35</sup> However, the SEC's legislative recommendation to Congress did not

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shareholders of record of a class of equity securities and \$1,000,000 of total assets at the end of its fiscal year.

<sup>32</sup> The *Special Study*, *op. cit. supra* note 20, ch. IX, at 17-62 found that those companies in the group with 300 or more shareholders manifested marked evidence of stock turn-over and broker-dealer interest as contrasted with companies with few shareholders and determined that companies having 300 or more shareholders irrespective of any asset test which was rejected would meet the appropriate standard for compliance with §§ 12, 13, 14 and 16 of the Securities Exchange Act of 1934. The *Special Study*, ch. IX, to V, at 61-62 found the following:

A comprehensive survey of issues of over-the-counter stocks—more comprehensive than any before attempted—leads to the conclusion that a number of shareholders criterion of coverage (the kind of standard principally adopted in prior legislative proposals) is both most theoretically sound and most workable. Comparison of corporate characteristics and numbers of shareholders of the corresponding issuers show that a clear relationship exists between shareholder size and the apparent degree of trading activity indicated by numbers of transfers of record and frequency of broker-dealer quotations. Little, if any, relationship between either of the foregoing and asset size is apparent. In the light of the detailed data set forth, including estimates of the total number of companies affected, a coverage standard of 300 shareholders is indicated. Administration needs suggest a phased program of reaching that standard gradually by at first adopting a higher figure and progressively lowering it as administrative means are made available.

<sup>33</sup> *Ibid.*; see notes 8-15 *supra*.

<sup>34</sup> See note 22 *supra*.

<sup>35</sup> *Ibid.*

follow the recommendation of the *Special Study* but, instead, recommended a gross asset test which, when the bill became law, amounted to a \$1,000,000 total asset test.<sup>36</sup> The SEC apparently felt that such a modest asset test would eliminate the administrative difficulties inherent in trying to "catch up with" relatively small companies failing to file required reports<sup>37</sup> and that the test would eliminate from the reporting requirements certain small companies with limited assets and, ergo, little investor interest, although there might be considerable speculative interest.<sup>38</sup>

What is the effect of these amendments on companies with securities that are unlisted and traded in the over-the-counter markets?

Section 12 (g) (1) of the Securities Exchange Act now provides, in substance, that every company which is engaged in interstate commerce or in a business affecting interstate commerce or the securities of which are traded by the use of the mails or the instrumentalities of interstate commerce and which has total assets exceeding \$1,000,000 must register within 120 days after the last day of its last fiscal year each class of equity security which was held of record by 750 or more persons—after July 1, 1966, the requisite number declined to 500 or more persons.<sup>39</sup> This requirement comes into effect only if several factors, discussed below, apply.

#### A. Interstate Commerce

It is difficult to imagine that the business of any company having as many as 500 shareholders would not have some effect upon interstate commerce, as that term has been defined by the Supreme Court of the United States.<sup>40</sup>

It should be here noted, however, that even though the securities or the transaction may be exempt under either section 3<sup>41</sup> or section 4<sup>42</sup> of the Securities Act,<sup>43</sup> such exemptions do not exempt a company meeting the minimum asset and stockholder tests from having to file under section 12 (g) (1) of the Securities Exchange Act. That is to

<sup>36</sup> See Statement of the Securities and Exchange Commission with respect to proposed 1964 Securities Act Amendments to §§ 12, 13, 14, 15(c), 15(d), 16, 20(c) and 32(b) of the Securities Exchange Act of 1934 and § 4(1) of the Securities Act of 1933, appearing in *Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives*, 88th Cong., 1st Sess., on H.R. 6789, H.R. 6793 and S. 1642, pt. I, at 169-70, Nov. 19, 1963.

<sup>37</sup> *Ibid.*

<sup>38</sup> See note 36 *supra*.

<sup>39</sup> 15 U.S.C. § 78l(g)1 (1964).

<sup>40</sup> *United States v. Darby*, 312 U.S. 100, 120 (1941); *North American Co. v. SEC*, 133 F.2d 148 (2d Cir. 1943), *aff'd*, 327 U.S. 686 (1946).

<sup>41</sup> 15 U.S.C. § 77c (1964).

<sup>42</sup> 15 U.S.C. § 77d (1964).

<sup>43</sup> Securities Act of 1933, 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-aa (1964).



say, while the intrastate exemption from the registration requirements of section 5 of the Securities Act of 1933 is afforded by section 3 (a) (11) of that act when a security is sold by an issuer domiciled and doing business in a state to bona fide residents of the same state,<sup>44</sup> that exemption has nothing whatever to do with section 12 (g) (1) and does not exempt, assuming some effect upon interstate commerce, in any way an intrastate issuer from the requirements of that section if such company has 500 record holders and \$1,000,000 of total assets on the last day of its fiscal year after July 1, 1966.<sup>45</sup>

For another example, suppose certain securities were initially exempt from the registration requirements of the Securities Act because the securities were issued by a building and loan association<sup>46</sup> or were issued by a common or contract carrier pursuant to section 20 (a) of the Interstate Commerce Act.<sup>47</sup> The issuer of such securities would be compelled to register such class of securities under section 12 (g) (1), if the requisite total asset and total record holder tests were met, regardless of the exemption provided by the Securities Act.

#### B. Total Assets

The Commission, in rule 12g 5-2, defines "Total Assets" to mean the total assets on the last day of the fiscal year shown on the issuer's balance sheet or the balance sheet of the issuer and its consolidated subsidiaries, whichever is larger, as prepared in accordance with the provisions of the Commission's basic accounting regulation S-X, which specifies the form and content of financial statements to be filed with the Securities and Exchange Commission.<sup>48</sup>

Total assets obviously means gross assets, not assets less liabilities. It is the position of the SEC that, if a company has both extensive assets and extensive liabilities, the need for disclosure to shareholders (through the use of the registration form required to be filed by section 12 (g) (1) and the reports required to be filed by section 13 of the Securities Exchange Act, including the requirements of sections 14 and 16) is greater than it may be were there fewer liabilities.

Parenthetically, what the total assets were a month or two prior to the end of the fiscal year, and what such total assets may be a month or two hence, are entirely irrelevant to the issue of whether registration is required. In the case of a seasonal business, this factor may

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<sup>44</sup> 15 U.S.C. § 77c(a) (11) (1964).

<sup>45</sup> 15 U.S.C. § 78l(g) (1964).

<sup>46</sup> 15 U.S.C. § 77c(a) (5) (1964).

<sup>47</sup> 15 U.S.C. § 77c(a) (6) (1964).

<sup>48</sup> 17 C.F.R. § 240.12g 5-2 (1964); see also note 51 *infra*.

become most important, since such a company may be able to adopt a fiscal year which would terminate at a time when total assets, including inventories, receivables and bank loans, are at a low point, enabling such company to avoid the registration requirements of section 12(g)(1).

### C. Termination

It should also be noted that the requirements for registration under section 12(g)(1) are twofold—a total assets test and a record holders test. However, the provision for terminating registration, section 12(g)(4), provides for termination “in 90 days or at such shorter period as the Commission may determine” only if the number of record holders of a class of security is reduced to less than 300 persons.<sup>49</sup> A reduction below \$1,000,000 total assets after a registration statement under section 12(g)(1) has been filed has no effect upon terminating the registration for that year. Because the act provides for voluntary registration (“any issuer may register any class of equity security not required to be registered by filing a registration statement pursuant to this paragraph”<sup>50</sup>), extreme care must be taken to take full advantage of the “total assets” test *before* filing is made. After such filing, that test becomes completely nugatory. For instance, a company’s own appraisal write-ups of its intangible assets, of its pricing of inventories or its valuations of real property ownership may not comply with the requirements of regulation S-X,<sup>51</sup> may be overstated and may, in fact, when properly figured, reduce “total assets” below the \$1,000,000 figure. It might prove most embarrassing if such a recomputation were “suggested” by the SEC and a resulting reduction in the dollar value of total assets below \$1,000,000 were to occur after the section 12(g)(1) filing had taken place rather than before. Accordingly, it is most important that the issuer’s counsel and accountants take a hard look at the issuer’s total assets to determine whether they can eliminate, through a legitimate means of reduction, valuations of “fat” intangibles which do not meet the requirements of regulation S-X.

Further, in a situation where a company has more than 500 record holders of a class of equity securities, and, between the last day of the last fiscal year and 120 days thereafter, when the registration form has to be filed with the SEC, a major acquisition may be made which increases the total assets from below \$1,000,000 to above that

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<sup>49</sup> 15 U.S.C. § 78l(g)(4) (1964).

<sup>50</sup> 15 U.S.C. § 78l(g)(1) (1964); see also note 31 *supra*.

<sup>51</sup> 17 C.F.R. § 210. ff (1964).

figure. In that situation, the company is not required to file for that fiscal year because its total assets were below \$1,000,000 on the last day of the fiscal year; but it would, of course, have to file at the end of the next fiscal year, unless it then failed to meet either the total assets or the record holders tests.

#### D. Class

The word "class" is defined by section 12 (g) (5) to "include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges."<sup>52</sup> This definition would seem to be sufficiently broad to encompass equity securities of different series which would be regarded by the SEC as of the same class, although the priorities, such as claims to dividends and claims on liquidation, or varying conversion provisions, or different sinking fund provisions (in the case of a convertible debenture which is an equity security) may not be identical. If the rights of the security holders, irrespective of differences in series, are comparable to the basic principles of a *pari passu* relationship, the existence of a single class may well be interpreted by the Commission.

#### E. Equity Securities

The term "equity security" is broadly defined by section 3 (a) (11) of the Securities Exchange Act to mean "any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right."<sup>53</sup> Furthermore, this section empowers the SEC to classify any other security as an equity security if the Commission deems such reclassification necessary, in the public interest and for the protection of investors.

Equity securities possess certain inalienable attributes such as the right to vote and to participate in profits and in the distribution of assets on liquidation.<sup>54</sup> The words "similar security," in the statute, would probably cover any security which had some indicia of ownership. If a company were to issue a type of security, such as a voting bond, which did not fall within the broad definition of section 3 (a) (11), and, if it appeared that the issuance of such security were prompted by a desire to evade the filing requirements of section 12 (g) (1), the SEC could merely exercise its prerogative to classify such security as an equity security.

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<sup>52</sup> 15 U.S.C. § 78l(g)(5) (1964).

<sup>53</sup> 15 U.S.C. § 78c(a)(11) (1964).

<sup>54</sup> 2 Loss, *op. cit. supra* note 8, at 1095.

The SEC in order to make this matter abundantly clear has adopted a new definition of a security:

The term "equity security" is hereby defined to include any stock or similar security, certificate of interest or participation in any profit sharing agreement, pre-organization certificate or subscription, transfer share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust, or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right.<sup>55</sup>

This definition seems broad enough to cover a security of any type which has in any shape, form or purpose an equity appearance or equity nature.

#### F. *Held Of Record*

The computation of the number of record holders of a class of equity securities is of equal importance in avoiding the registration requirements of section 12(g) (1), as the determination of "total assets." "Held of Record" has been defined by the Commission in rule 12g 5-1 to mean that securities are "deemed to be 'held of record' by each person who is identified as the owner of such securities on records of security holders maintained by or on behalf of the issuer. . . ."<sup>56</sup>

Although the Commission initially proposed that "held of record" should include beneficial holders, a definition which would have required the issuer to ascertain the number of individual owners for whom securities are held by brokers or dealers in customers' accounts or by banks in custody or advisory accounts,<sup>57</sup> the rule, as adopted, ostensibly speaks only in terms of record holders. In announcing the adoption of the rule, the SEC stated that it would determine at a future date, in the light of experience, whether inclusion of beneficial accounts is necessary or appropriate to prevent circumvention of the act and to achieve the intended coverage on a uniform and acceptable basis.<sup>58</sup>

Those companies with holders of record totaling somewhere between 500 and 750 had the opportunity until July 1, 1966, to determine whether there were any legitimate means in which the number

<sup>55</sup> 17 C.F.R. § 240.3 a 11-1 (1964), adopted in SEC Securities Exchange Act Release No. 34-7581, April 23, 1965, 30 Fed. Reg. 6115 (1965).

<sup>56</sup> 17 C.F.R. § 240.12g 5-1 (1964).

<sup>57</sup> See SEC Securities Exchange Act Release No. 7426, September 15, 1964; cf. SEC Securities Exchange Act Release No. 7492, January 5, 1965.

<sup>58</sup> 17 C.F.R. § 240.12g 5-1(a) (3) (1964).

of holders of record could be reduced so that such companies would have less than 750 record holders at that time. Companies with shareholders approaching 500 now have until the end of their fiscal years such an opportunity to make a legitimate reduction in the number of their shareholders.<sup>59</sup> The most obvious method would be for the issuer to buy up some of such equity securities or redeem them. The mere updating of the transfer books may well eliminate duplication by beneficial ownership where one shareholder holds in different names. Another simple method would be to persuade John Adams, John and Mary Adams and Mary Adams to combine and become one record holder. The issuer could also permit an interested shareholder to examine the stock record book and to make a tender offer to other shareholders, thereby diminishing the size of the record holders' list. So long as the issuer obeys the warning implicit in rule 12g 5-1 (b) (3) not to contrive to circumvent the purposes of the rule,<sup>60</sup> and so long as he skirts the narrow path of evasion for the well-settled highway of avoidance, the issuer has many opportunities, in effect, to reduce the number of record holders.

Of course, in any of the above dealings, the issuer must take into careful consideration the problems inherent in the Securities Exchange Act's section 10b<sup>61</sup> and rule 10b-5,<sup>62</sup> promulgated thereunder. Extreme caution should be employed to determine whether disclosures of certain material factors or information to prospective purchasers or sellers of securities should be made.<sup>63</sup> Problems involving section 10b and rule 10b-5, however, are beyond the scope of this Article.

According to SEC rule 12g 5-1, securities held by the following "shall be deemed held by one person:" (1) where records have not been maintained in accordance with accepted practice, a person who would have been a holder of record, if the records had been maintained properly; (2) securities held of record by a corporation, a partnership, a trust, whether or not the trustees are named, or other organization; (3) securities held of record by one or more persons as trustees, executors, guardians, custodians or in other fiduciary capacities with respect to a single trust estate or account; (4) securities held by two or more persons as co-owners; (5) each bearer certificate unless the issuer can establish that, if registered, such certificates would be held of record under the rule by a lesser number; and (6)

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<sup>59</sup> 15 U.S.C. § 781(g) (1964).

<sup>60</sup> 17 C.F.R. § 240.12g 5-1 (b) (3) (1964).

<sup>61</sup> 15 U.S.C. § 78j(b) (1964).

<sup>62</sup> 17 C.F.R. § 240.10b-5 (1964).

<sup>63</sup> See SEC v. Texas Gulf Sulphur Co., complaint filed, Civil No. 65-1182, S.D.N.Y., April 19, 1965.

securities held substantially in similar names, *i.e.*, Rebecca Adams and Mrs. Howard Adams, where the address or other facts are such as to give the issuer reason to believe the different named persons are, in fact, one and the same.<sup>64</sup> At the outset, this rule does provide, however, that corporate records must be maintained in accordance with accepted practice. As noted in subparagraph 1 of rule 12g 5-1(a), where stock ownership records are not kept in accordance with accepted practice, the obligation is squarely placed upon the corporate issuer to make the determination as to stock ownership so as to reach the same result it would have arrived at had the records been kept in an "accepted practice" manner.<sup>65</sup> The rule does not define "accepted practice." It would seem that the corporation would at least have to keep its stockholder or transfer records in accordance with state law, including a record of the names and addresses of its stockholders.

As an example of the way the SEC will unquestionably determine holders of record, suppose a corporation has a record of share ownership in John Adams, John and Mary Adams and Mary Adams, all of the same address, the SEC would *not* add these three different named ownerships together but would count these as three separate holders.

It is interesting to note that rule 12g 5-1, as eventually promulgated by the Commission, permits the issuer to treat a security as being held by a single holder even though that holder is a brokerage firm, a corporation or a partnership fiduciary, and the issuer knows or has reason to know that the securities are held in a "street name" for many beneficiaries. Additionally, the SEC dropped its original proposal which would have required an issuer to count the number of direct beneficial owners of its securities which were held by a stock purchase, savings, pension, retirement or other comparable employee benefit plan.<sup>66</sup>

Despite the orderly way that rule 12g 5-1(a) seems to handle these fairly routine problems, rule 12g 5-1(b) seems to be getting at situations where there is an appearance of an attempt to circumvent or frustrate the record ownership rule by lumping together beneficial owners into a single record owner. Subsection (b)(1) specifies that where the issuer has knowledge that securities are held subject to a voting trust, deposit agreement or other similar arrangement, the underlying securities will be deemed held by the record holders of the voting trust certificates, certificates of deposit or other similar evidences of interest in the securities.

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<sup>64</sup> 17 C.F.R. § 240.12g 5-1(a) (1964).

<sup>65</sup> 17 C.F.R. § 12g 5-1(a)(1) (1964).

<sup>66</sup> See notes 57 and 65 *supra*.

The rule does, however, permit the issuer to rely in good faith on information received in reply to a request for shares from a non-affiliated issuer of voting trust certificates or other evidences of interest.<sup>67</sup> Since the rule uses the words "to the knowledge of the issuer," it would seem to require the issuer to ask the record holder whether he is a voting trustee. If the record holder is not an affiliate of the issuer, the issuer can rely in good faith on what the non-affiliated issuer of the certificates tells such issuer unless, of course, the issuer by reason of the transfer records or otherwise, knows the record holder is a voting trustee. Where the record holder is an affiliate, a different result may follow. Rule 12b-2 defines an affiliate to mean "person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified."<sup>68</sup> In view of the broadness of this definition, it probably is not possible for an issuer to claim ignorance of the fact that its affiliate is a voting trustee. Actually, the absence of such knowledge is extremely unlikely.

Another type of security covered by subsection 12g 5-1 (b)<sup>69</sup> consists of securities which are primarily loans in which the borrower is required to qualify formally as a member of the issuer by taking a form of security ownership in order to effect the loan. This is common practice with savings and loan associations, building and loan associations, cooperative banks, etc. In these situations, since the interest or security ownership is repurchased by the issuer when the loan is paid off, there is deemed to be nothing more than a reserved ownership which is not considered held of record by anyone.

Finally, there is a catch-all provision mentioned above which applies where the record ownership is obviously designed to evade the filing requirements of section 12g. Rule 12g 5-1, subsection (b) (3) states that, if the issuer knows or has reason to know that the form of record holding of securities is designed "primarily to circumvent" 12g(1) or 15(d), "the beneficial owners of such securities shall be deemed to be the record owners."<sup>70</sup>

### III. EXEMPTIONS

The 1964 amendments do establish exemptions for certain companies having total assets and numbers of record holders which otherwise meet the tests for registration. These exemptions refer to the na-

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<sup>67</sup> 17 C.F.R. § 240.12g 5-1 (a), (b) (1964).

<sup>68</sup> 17 C.F.R. § 240.12b-2 (1964).

<sup>69</sup> 17 C.F.R. § 240.12g 5-1 (b) (1964).

<sup>70</sup> 17 C.F.R. § 240.12g 5-1 (b) (3) (1964).

ture or character of the issuer, and are, therefore, unlike the exemptions under the Securities Act of 1933, where the differences between an exempt security and an exempt transaction have some significance and where the resolution of a particular factual situation will often determine the availability of the particular exemption. Thus, section 12(g)(2)<sup>71</sup> provides seven separate exemptions for:

(1) a security listed and registered on a national securities exchange. Since a listed security must comply with sections 12, 13, 14 and 16 of the Securities Exchange Act, there is obviously no need for duplication by subjecting such companies to the similar requirements of the 1964 amendments;

(2) investment company or mutual fund securities issued pursuant to the Investment Company Act of 1940. Again, these securities are presently regulated under the Investment Company Act of 1940 which has requirements comparable to those in the 1964 amendments;

(3) share accounts in savings and loan associations, building and loan associations, cooperative banks, homestead associations or similar institutions supervised and subject to examination by state or federal authorities having supervisory responsibility over such institutions. This exemption is based on the fact that, although a share account often may resemble a security, its real effect and purpose is to accomplish a type of withdrawal deposit, as, for example, when an underlying loan balance is paid. The exemption is specifically made inapplicable to the permanent non-withdrawable capital of such institutions, whether such deposits are designated "permanent stock," "guaranty stock," "permanent reserve stock," or otherwise to indicate non-withdrawable capital;

(4) securities issued by an institution "organized *and* operated *exclusively* for religious, educational, benevolent, fraternal, charitable or reformatory purposes and not for pecuniary profit" to itself or to an individual (Emphasis supplied.);

(5) securities of a "cooperative association" or a comparable federation thereof, as defined in the Agricultural Marketing Act, approved June 15, 1929, as amended;

(6) dividend-paying securities issued by certain nonprofit mutual or cooperative organizations supplying commodities or services as a primary benefit to its members, where the security is part of a class issued to such members or their successors who purchase such commodities or services;

(7) securities issued by insurance companies which (a) file reports comparable to those required under the federal statute, section

<sup>71</sup> 15 U.S.C. § 78l(g)(2) (1964).



12 (g) (1) with a state insurance commission in a form substantially conforming to that prescribed by the National Association of Insurance Commissioners (N.A.I.C.), (b) have proxy solicitation material subjected to state regulation conforming to that prescribed by the N.A.I.C., and (c) by July 1, 1966, have insider trading subjected to regulation under the proper domiciliary state law substantially equivalent in scope to section 16 of the Securities Exchange Act. This anomalous exemption primarily resulted from the activities of the insurance company lobby which persuaded the House that the federal authorities would, in the Senate version of 1964 amendments, encroach upon a preserve historically reserved to the states. In an event, this exemption became law probably only because the N.A.I.C., in effect, gave its firm undertaking that a necessary and comparable regulatory scheme would in the early future be provided for insurance companies at the state level.<sup>72</sup>

Many states at the time this legislation became law had no statutory power to require comparable reports or to regulate insider trading of their domestic insurance companies. Notable exceptions are New York<sup>73</sup> and California which have enacted statutes empowering their state insurance superintendents to require reports similar to those of section 16 and to restrict, upon the penalty of disgorging profits, insider trading on short swing (six months or less) transactions.

The SEC, apparently persuaded that many states lacked and could not quickly enact necessary enabling legislative authority to regulate the proxy solicitation and insider trading of insurance companies,<sup>74</sup> extended the time limit when the conditions of the exemption must be met by all insurance companies, to July 1, 1966.

A type of securities exempted from the registration requirements of section 12 (g) (1) under the original bill were those of foreign issuers. As originally drafted, the bill would have given to foreign issuers an outright exemption, probably because the jurisdictional power of the SEC is not very effective beyond the continental limits of the United States. In the House hearings, some committee members expressed their belief that American investors needed more protection and disclosure with regard to foreign companies than with regard to American companies directly subject to personal jurisdiction. Although this position leaves unsolved the practical problem of how the SEC might obtain jurisdiction over a foreign issuer,<sup>75</sup> the House replaced the

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<sup>72</sup> H.R. REP. NO. 1418, 88th Cong., 2d Sess. (1964).

<sup>73</sup> *Ibid.*

<sup>74</sup> Note 72 *supra*.

<sup>75</sup> We wish to point out, however, that ample jurisdiction exists over domestic underwriters, broker-dealers and sellers of foreign securities.

outright exemption of foreign issuers with a qualified exemption. The securities, including certificates of deposit for such securities, of foreign issuers are not exempt from the registration requirements of section 12(g)(1); but the SEC is given broad exemptive powers. The House Interstate and Foreign Commerce Committee Report specifically explains this scheme as merely a "procedural change" and not one designed in any way to limit the SEC's administrative flexibility "to exempt partially or completely, foreign securities and certificates of deposit therefore . . . when such action is appropriate." Mere non-compliance by a foreign issuer with the registration requirements will not result in the illegality of the trading in the securities of such issuer by American brokers, dealers and investors and will not give rise "to civil liabilities to the broker-dealers trading in such securities."<sup>76</sup>

Finally, the legislation took a somewhat different twist regarding banks. As originally introduced, the amendments provided for a form of delegation of the SEC regulatory powers and functions, in whole or in part, with respect to sections 13, 14 and 16 of the Securities Exchange Act. Each particular bank would have had the option to request that its usual federal banking regulatory agency exercise these powers.<sup>77</sup> Prior to any such request, the SEC would exercise such powers and functions. As enacted, section 12(g)(1) provides, in substance, that the reporting, proxy, and insider trading provisions with respect to bank securities are subject to administration by the appropriate federal bank regulatory agency.<sup>78</sup> These agencies would be the Comptroller of the Currency as to national banks, the Federal Reserve Board as to state member banks of the Federal Reserve System, and the Federal Deposit Insurance Corporation as to all other insured banks.<sup>79</sup>

Contrary to the SEC recommendation, the Frear and Fulbright Bills each exempted both banks and insurance companies from the reporting, proxy and insider trading requirements.<sup>80</sup> The SEC *Special Study*<sup>81</sup> recommended that there be no such exemptions because regulation of banks and insurance companies had traditionally been aimed primarily, if not entirely, at protecting depositors or policy

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<sup>76</sup> See *Report of House Interstate and Foreign Commerce Committee*, May 19, 1964, accompanying H.R. 6793, at 11.

<sup>77</sup> H.R. REP. NO. 1418, 88th Cong., 2d Sess. (1964).

<sup>78</sup> *Ibid.*

<sup>79</sup> See *Report of House Interstate and Foreign Commerce Committee*, May 19, 1964, 1(a), at 8, 9, accompanying H.R. 6793.

<sup>80</sup> See *Report of House Interstate and Foreign Commerce Committee*, May 19, 1964, 1(b) at 9, 10, accompanying H.R. 6793. See notes 8, 12 and 14 *supra*.

<sup>81</sup> See note 7 *supra*.

holders rather than security holders, and because reporting by these types of companies was in fact no better than in the case of unlisted companies generally. Now, because of the 1964 amendments, security holders of banks and insurance companies are for the first time able to obtain and examine disclosures of a material nature which were heretofore generally unavailable with respect to either banks or insurance companies.

There is one final exempting power that needs mention. Section 12(h) provides in substance that the SEC may "by rules and regulations" or "upon application" by an interested person "by order, after notice and opportunity for hearing, exempt in whole or in part," and conditionally, "any issuer or class of issuers or its insiders from" sections 13, 14, 15(d) and 16 of the Securities Exchange Act for as long as the SEC deems such action appropriate.<sup>82</sup> The SEC must find such action consistent "with the public interest or the protection of investors" taking into consideration "the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise."<sup>83</sup>

In implementation of this exemptive power, the SEC has adopted rule 12h-2 which exempts (1) certain interests, nontransferable except upon death, in employee stock bonus, profit sharing, pension, retirement, incentive, thrift savings or similar plans, (2) certain interests in a bank common trust fund and (3) certain securities which will no longer be outstanding sixty days after registration is required.<sup>84</sup> This latter provision would cover the situation where a company which technically meets the requisite total assets and numerical record holders tests is in the process of liquidation.

#### IV. THE MECHANICS AND OBLIGATIONS OF REGISTRATION

Assume that an issuer on the last day of its fiscal year is engaged in a business which has some effect on interstate commerce, has more than \$1,000,000 of total assets and has 500 or more record holders of a class of equity securities. In such a case, the issuer must register with the SEC. What does the issuer do and how? Section 12(g)(1) provides that a registration statement must be filed within 120 days after the close of the fiscal year in which the issuer has become subject to the requirements.<sup>85</sup> The SEC, by rule 12g-1, originally extended

<sup>82</sup> 15 U.S.C. § 781(h) (1964).

<sup>83</sup> *Ibid.*

<sup>84</sup> 17 C.F.R. § 240.12h-2 (1964).

<sup>85</sup> 15 U.S.C. § 781(g)(1) (1964).

the time when such registration statements were to be filed to April 30, 1965.<sup>86</sup> That extension of time, however, was inapplicable to companies required to file reports pursuant to sections 13 or 15(d).<sup>87</sup>

The statute further provides that the registration statement shall become effective sixty days after the filing or at such "shorter period as the Commission may direct."<sup>88</sup> Because the statute uses the compelling word "shall," there is a real question as to whether the SEC has the power to delay or postpone the effective date. In addition, the statute specifies that, until effective, the registration statement shall be deemed not to have been filed for purposes of section 18, which provides for civil liabilities for misleading statements.<sup>89</sup> Section 18, which has had little, if any, use prior to the adoption of these amendments, imposes liability upon any person who makes a false statement in any application, report or document filed with the SEC pursuant to the act or to any SEC rule or regulation. Such liability inures to the benefit of any person who has innocently relied upon such falsity and indemnifies him against damages caused by such reliance.<sup>90</sup> In Securities Act Release No. 7500, dated January 5, 1965, the SEC sought to emphasize, by rule, the absence of such liability until the effective date which generally occurs sixty days after the filing.<sup>91</sup>

So far as sections 13, 14 and 16 are concerned, neither annual reports, periodic reports, proxy material nor insider reports on form 3 need to be filed until the effective date.<sup>92</sup> However, with regard to section 16(b), it is most important to note that for purposes of matching a sale and purchase or a purchase and sale by an insider in a short swing transaction, the time when the first purchase or sale is made may occur during a period six months prior to the effective date of the registration statement. In other words, a purchase or sale made on or after the effective date may be matched with a sale or purchase occurring prior to such effective date.

Because of the number of companies which for the first time filed registration statements on or just prior to April 30, 1965, it is probable that some became effective in defective or incomplete form, since, unfortunately, the SEC staff was not able to review the filings so thoroughly as it would either have preferred doing or as it generally does in the case of its review of registration statements filed in connection

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<sup>86</sup> 17 C.F.R. § 240.12g-1(b) (1964).

<sup>87</sup> *Ibid.*

<sup>88</sup> 15 U.S.C. § 78l(g)(1) (1964).

<sup>89</sup> *Ibid.*

<sup>90</sup> 15 U.S.C. § 78r (1964).

<sup>91</sup> See 15 U.S.C. § 78l(g)(1) (1964).

<sup>92</sup> 17 C.F.R. § 240.12b-6 (1964).

with a proposed sale of additional or new securities under the Securities Act of 1933.

It is probable that henceforth the staff of the SEC's Division of Corporation Finance will employ techniques comparable to those now used in connection with a Securities Act registration statement.<sup>93</sup> Thus, some time during the sixty days following the filing, the issuer should receive a letter of comment, sometimes referred to colloquially as a deficiency letter, in which the SEC staff raises questions and makes suggestions designed to elicit more information to broaden the disclosure. The issuer will then have an opportunity to make any necessary changes in the filed statement to effect compliance with SEC standards and to avoid the possibility of the registration statement's containing defective or improper material, giving rise to civil or criminal liability. If, on the other hand, the statement does become effective in defective form, containing false or misleading statements, or if the statements made therein subsequently turn out to be inaccurate or misleading, then liability under section 18(a) may attach, provided that a purchaser can sustain the difficult burden of proof with regard to reliance and damages.<sup>94</sup>

Registration pursuant to section 12(g)(1) is accomplished either by the use of form 10 or the optional short form 8-A, where the issuer has other classes or a class of securities registered on a national securities exchange.<sup>95</sup> Form 10 is designed to elicit basic information about the filing company and is somewhat similar to the basic registration form S-1 used to register securities for public distribution under the Securities Act of 1933. The first page of the SEC release announcing the adoption of form 10 points out that, unlike an S-1 form which requires triplicate filing, eight copies of a section 12(g)(1) registration statement on a form 10 must be filed,<sup>96</sup> one of which must be manually signed, the others conformed. If the company is listed on a national securities exchange, the copy of form 10 which the company is required to file with that exchange must also be manually signed.<sup>97</sup> Four of the copies filed with the SEC are to be kept in the SEC principal office, for staff use and public inspection. The four additional copies are distributed to the three principal SEC regional

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<sup>93</sup> See PRACTICING LAW INSTITUTE, *WHEN CORPORATIONS GO PUBLIC* 98 (Israels & Duff ed. 1962); ROBINSON, *GOING PUBLIC*, ch. 8 (1961).

<sup>94</sup> 15 U.S.C. § 78r (1964).

<sup>95</sup> 17 C.F.R. § 249.210 (1964) and 17 C.F.R. § 249.208a (1964); form 10, as amended, SEC Securities Exchange Act Release No. 34-7544, April 5, 1965, 30 Fed. Reg. 3423 (1965); SEC Securities Exchange Act Release No. 34-7508, January 15, 1965, 30 Fed. Reg. 702 (1965).

<sup>96</sup> 17 C.F.R. § 249.210 (1964).

<sup>97</sup> *Ibid.*

offices of New York City, Chicago and San Francisco, and the fourth is filed in the SEC regional office for the region where the issuer has its principal office.

Since the form is not intended as a selling document for general circulation to security holders or to the public, this technique of making the information contained in the registration statement readily available to interested persons is most revealing. The form 10 registration statement is, generally speaking, a liability document and not so much a selling document as is, at least in part, a prospectus prepared in accordance with form S-1 under the Securities Act of 1933. This distinction is primarily due to the fact that with a form S-1 registration under the Securities Act, there is an underwriter who does not want the prospectus couched in such pessimistic terms as to impede sales of the underlying security; whereas, in the case of a form 10, there is no underwriter involved and the securities being registered are not being sold by the issuer.

The form 10 contains "General Instructions" which must be read and understood fully. The usual SEC caveat must be heeded, that the form is not merely a series of blanks to be filled in, but should serve only as a guide in the preparation of the registration statement which must contain the specific item numbers and captions.<sup>98</sup> The information given must be current as of a date reasonably "close to the date of filing."<sup>99</sup>

Instruction E of form 10 relates to SEC rule 24 b-2 which permits a request to the SEC for confidential treatment of information where public disclosure might be detrimental to the best interests of the issuer. For instance, where a contract contains trade secrets or a formula not known to competitors, the SEC may grant confidential treatment of such secret information, thus permitting the issuer to omit the public disclosure thereof. It should be noted, however, that the SEC does not grant such confidential treatment unless a need for such treatment is clearly manifested.<sup>100</sup>

Instruction F relates to a provision which permits incorporation by reference to information contained in a Securities Act prospectus.<sup>101</sup>

The first page of form 10 is a facing sheet on which appears the issuer's name, state of incorporation or organization, address, Internal Revenue Service employer identification number, the title of each class of securities to be registered, the name of the exchange on which each class is registered, and the title of the class of securities being

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<sup>98</sup> 17 C.F.R. § 249.210 C(a) (1964).

<sup>99</sup> 17 C.F.R. § 249.210 C(b) (1964).

<sup>100</sup> 17 C.F.R. § 240.24b-2 (1964).

<sup>101</sup> 17 C.F.R. § 249.210 F (1964).

registered pursuant to section 12(g). As is the case with all SEC forms, the balance of form 10 is a series of items, each followed by instructions. These must be read very carefully, item by item, and the information must be supplied with meticulous care. There are eighteen items in which the issuer must supply a variety of information about itself, its management and its principal security holders.<sup>102</sup>

Balance sheets and profit and loss statements must also be filed as part of the form 10 registration statement. These documents must be certified by independent public accountants.<sup>103</sup> The form and content of the balance sheets and profit and loss statements, including the basis of consolidation, the statements as to surplus, and whatever schedules are to be filed in support thereof, are governed by the SEC basic accounting rule, regulation S-X.<sup>104</sup>

Attached to form 10 are the "Instructions as to Financial Statements" which set forth in detail the financial information which must accompany the filing of form 10.<sup>105</sup> Finally, there are specific instructions as to those exhibits which must accompany the filing of form 10.<sup>106</sup>

With regard to the financial statements of a section 12(g) company which has never before filed with the SEC, the most important immediate problems relate to questions as to whether the accountant is independent and whether the financial statements submitted reflect the application of accounting principles which have authoritative support and which have not been formally disapproved by the SEC. Where financial statements are prepared in accordance with principles for which there is no substantial authoritative support, the SEC presumes such statements to be "misleading or inaccurate," despite whatever disclosure may be made by the accountant.<sup>107</sup> As for the problem of an accountant's independence,<sup>108</sup> the SEC has refused to recognize an accountant who is not, in fact, independent; and an

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<sup>102</sup> *Ibid.* In addition to item 1 "General Information", relating to year and form of organization, the following types of information must be supplied: Item 2, Parents and Subsidiaries of Registrants; Item 3, Description of Business; Item 4, Description of Property; Item 5, Organization Within Five Years; Item 6, Pending Legal Proceedings; Item 7, Directors and Officers; Item 8, Indemnification of Directors and Officers; Item 9, Remuneration of Directors and Officers; Item 10, Options to Purchase Securities; Item 11, Principal Holders of Securities; Item 12, Number of Equity Security Holders; Item 13, Interest of Management and Others in Certain Transactions; Item 14, Capital Stock to be Registered; Item 15, Long-Term Debt to be Registered; Item 16, Other Securities to be Registered; Item 17, Recent Sales of Unregistered Securities; Item 18, Financial Statements and Exhibits.

<sup>103</sup> 17 C.F.R. § 249.210 (1964), *Instructions as to Financial Statements*.

<sup>104</sup> 17 C.F.R. § 249.210 (1964), *Instructions as to Financial Statements*.

<sup>105</sup> *Ibid.*

<sup>106</sup> 17 C.F.R. § 249.210 (1964), *Instructions as to Exhibits*.

<sup>107</sup> SEC Accounting Series Release No. 4, April 25, 1938.

<sup>108</sup> See SEC rule 2-01 of regulation S-X and Securities and Exchange Commission Accounting Series Release No. 81, December 11, 1958.

accountant will not be considered independent with respect to any company or any of its parents or subsidiaries in which he has, or had during the period covered by his report, any direct financial interest or any material indirect financial interest, or with which the accountant is, or was during the period, connected as a promoter, underwriter, voting trustee, director, officer or employee.<sup>109</sup>

Another problem facing a company filing under section 12 (g) for the first time arises from the SEC requirement that the issuer file a certified three year income statement. Sound accounting practice, since the *McKesson & Robbins* case in 1939,<sup>110</sup> has required certifying accountants to observe a company's procedures in taking physical inventories.<sup>111</sup> Where the accountant is first employed at or about the time of the balance sheet date, or only a short time prior to filing, he may not be able to certify as to the procedures for taking inventories during previous years, in which case his certification would have to contain a qualification as to such inventories. Prior to 1962, the SEC allowed accountants who had not been retained in prior years to qualify their certification in registration statements with respect to earlier inventories and inventory-taking procedures employed by the issuer, which procedures the accountant did not physically observe. In 1962, however, the SEC issued Accounting Series Release No. 90 in which it was categorically stated that such qualifications would be unacceptable.<sup>112</sup> The effect of this determination was to compel issuers desirous of selling securities under the provisions of the Securities Act of 1933 to postpone such offerings until their financial statements could be certified to in unqualified form by a certified accountant who had physically observed the issuer's procedures for taking inventories for three years. In the case of first-filing section 12 (g) companies, the same problem may arise; and the accountant may have to qualify his certification for the same reasons as mentioned above. While the SEC has not issued any blanket exemptions or waivers of this accounting requirement for section 12 (g) companies, the probability is that the SEC will accept a filing containing such a qualification on the theory that the passage of time will soon correct the situation. Further, section 12 (g) is a compulsory, statutory scheme with no permissive elements, and no sales of new securities are involved. The purpose is to compel companies to disclose facts about themselves to the general public. In the Securities Act, on the other hand,

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<sup>109</sup> *Ibid.*

<sup>110</sup> RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE, pt. III, at 4.3-8 (2d ed. 1966).

<sup>111</sup> SEC Accounting Series Release No. 19 (1940).

<sup>112</sup> SEC Accounting Series Release No. 90 (1962).



the statute is permissive and its purpose is to prevent further harm to the public by issuers selling their securities. Therefore, there the prospectus as a selling document must contain unqualified financials.

## V. CONTINUING RESPONSIBILITIES

Once registered, the registration can be terminated only if the number of record holders falls below 300; and then, such termination will occur ninety days after the filing of a certification to that effect, unless the SEC decides to terminate earlier. Otherwise, the issuer must continue to observe the securities requirements.

### A. Periodic Reports

Following an effective registration, the issuer must consider the filing of reports required by section 13 of the Securities Exchange Act. These reports include the annual report on form 10K, the semi-annual report on form 9K, and the so-called current or periodic report on form 8K. The general purpose of these additional reports is to up-date the information and data filed in the form 10.<sup>113</sup> These forms, as well as form 10, are readily available at the SEC's regional office.<sup>114</sup>

The annual report on form 10K must be filed with the SEC within 120 days following the close of the fiscal year. Like the form 10, eight copies, one of which must be manually signed and the others conformed, must be filed at the SEC home office. Form 10K contains fourteen items with instructions, generally paralleling the items which appear in the form 10.<sup>115</sup> Up-dated financial statements must be prepared in accordance with SEC regulation S-X and attached to the form 10K.<sup>116</sup>

The semi-annual report on form 9K must be filed within forty-five days after the end of the period covered thereby. Obviously, only one semi-annual report must be filed, and it covers the first half of the annual period. The form calls for only certain minimal information specified in nine items, plus an item which calls for the listing under "Remarks" of any other material information which is "necessary to make the information called for by this form not misleading."<sup>117</sup> Formal statements of profit and loss and earned surplus are not called for, and the information submitted does not have to be certified.

<sup>113</sup> 17 C.F.R. § 249.310, 249.309, 249.308 (1964).

<sup>114</sup> The SEC Regional Office in Texas is in the post office building in Fort Worth, Texas; and the SEC home office is located at 500 Capital Mall, North, Washington, D.C.

<sup>115</sup> 17 C.F.R. § 249.310 (1964); cf. 17 C.F.R. § 249.210 (1964).

<sup>116</sup> See *Instructions as to Financial Statements*, 17 C.F.R. § 249.310 (1964).

<sup>117</sup> 17 C.F.R. § 249.309 (1964).

The current report on form 8K is to be filed within ten days after the close of each month during which any of the significant events specified in the form occurred. The form contains fifteen items, and, where necessary, certified financial statements may have to accompany the filing.<sup>118</sup>

Obviously, before any financial statements are prepared for a company, both the accountant preparing them, the chief financial officer or controller of the issuer, and the latter's counsel should be thoroughly familiar with the "Instructions as to Financial Statements" contained in the form. They should also be completely conversant with SEC regulations S-X,<sup>119</sup> the SEC's Accounting Series Releases of which there are one hundred, the opinions and bulletins published by the Accounting Principles Board of the American Institute of Certified Public Accountants and its predecessor, the Committee on Accounting Procedures, as well as with the statements of auditing procedures issued by the American Institute of Certified Public Accountants.

### B. Proxy Regulations

Finally, the section 12 (g) company is required to comply with the proxy regulations promulgated under section 14 of the Securities Exchange Act of 1934;<sup>120</sup> and such company's officers, directors and ten per cent stockholders must comply with the filing requirements of section 16 (a)<sup>121</sup> relating to stock ownership and with the disgorgement of profits provision of section 16 (b)<sup>122</sup> on any short swing profits made from purchases and sales which can be matched with any sales and purchases occurring within a six months' period.

The basic purpose of section 14 and the SEC proxy rules is to assure that security holders exercising their corporate franchise do so on the basis of accurate and adequate information.<sup>123</sup> Section 14 (a) of the Securities Exchange Act makes it unlawful for any person to solicit a proxy or a consent or authorization in respect of any security registered pursuant to section 12 unless in compliance with the SEC's rules and regulations.<sup>124</sup> Rule 12b-6 provides that for purposes of section 14, securities are deemed registered when the registration statement becomes effective.<sup>125</sup> Rule 12g-1 (b) provides that sollicita-

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<sup>118</sup> 17 C.F.R. § 249.308 (1964).

<sup>119</sup> 17 C.F.R. § 240.210 (1964).

<sup>120</sup> 15 U.S.C. § 78u (1964).

<sup>121</sup> 15 U.S.C. § 78p(a) (1964).

<sup>122</sup> 15 U.S.C. § 78p(b) (1964).

<sup>123</sup> 17 C.F.R. § 240.14 a-1 through 240.14 a-11 (1964).

<sup>124</sup> 15 U.S.C. § 78n (1964).

<sup>125</sup> 17 C.F.R. § 240.12b-6 (1964).

tions were exempt from the proxy rules until two months after the last day when a registration statement was due or until December 31, 1965, whichever was earlier.<sup>126</sup> Thus, companies whose registration statements were filed, for example, on April 30, 1965, would have been subject to the proxy rules until the effective date June 30, 1965, two months after filing. In most cases the SEC rules were probably not applicable to section 12(g) companies until the 1966 proxy season since most section 12(g) companies presumably were exempt from the proxy rules as of December 31, 1965. Between 1935 and 1964, the SEC, pursuant to the provisions of section 14(a), adopted a series of rules entitled regulation 14 (the proxy rules, so called) which has eleven rules and two schedules.<sup>127</sup> Schedule 14A applies to all solicitations and contains, in twenty-one items, information which must be disclosed to security holders in a proxy statement. Schedule 14B applies to contested elections and contains, in five items, the information which must be supplied in a statement furnished to security holders by a "participant" in such proxy contest.

A solicitation is defined under rule 14a-1 to include: "(1) any request for a proxy whether or not accompanied by or included in a form of proxy; (2) any request to execute or not to execute, or to revoke a proxy; or (3) the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."<sup>128</sup> A solicitation would also be involved in any writings which form part of a "continuous plan ending in solicitation and which prepares the way for its success."<sup>129</sup> Speeches, planted newspaper articles or press releases, depending on circumstances, may also constitute solicitation. Generally speaking, mere ministerial acts, such as forwarding proxy material by a broker to the beneficial owners of securities held in street name or the sending out by the company to its securities holders of an annual or quarterly report, do not constitute solicitation.<sup>130</sup>

The basic purpose of regulation 14 is to require that each security holder solicited must be furnished with a proxy statement which contains information required by schedule 14A.<sup>131</sup> The proxy rules also

<sup>126</sup> 17 C.F.R. § 240.12g-1(b) (1964).

<sup>127</sup> 17 C.F.R. § 240.14a-1-14a-1 (1964) and schedule 14A and schedule 14B.

<sup>128</sup> 17 C.F.R. § 240.14a-1 (1964).

<sup>129</sup> SEC v. Okin, 132 F.2d 784, 786 (2d Cir. 1943); SEC v. Topping, 85 F. Supp. 63 (S.D.N.Y. 1949); Dyer v. SEC, 291 F.2d 774 (8th Cir. 1961); Dyer v. SEC, 287 F.2d 773 (8th Cir. 1961).

<sup>130</sup> 17 C.F.R. § 240.14a-1 (1964).

<sup>131</sup> 17 C.F.R. § 240.14a-1 14a-11 (1964) and schedule 14A as amended on December 22, 1965. See SEC Securities Exchange Act Release No. 34-7775. Schedule 14A requires the following information: Item 1, A statement as to whether or not the proxy

specify the form and content of the proxy which is to be used and require that the proxy contains a means, such as a series of printed boxes by which the person solicited can specify by ballot his approval or disapproval as to each matter "referred to as intended to be acted upon other than elections to office."<sup>132</sup> The proxy must contain a space for dating, and the use of an undated or postdated proxy is prohibited.<sup>133</sup>

Where the proxy relates to an annual meeting at which directors are to be elected, the proxy statement must be accompanied or preceded by an annual report containing financial information as, in management's opinion, will adequately reflect the financial condition and operation of the company.<sup>134</sup>

Three preliminary copies of the proxy statement, the form of the proxy and any other soliciting material to be distributed therewith, such as the president's letter, must be filed with the SEC at least ten days prior to mailing.<sup>135</sup> Any material distributed later must be filed two days before mailing.<sup>136</sup> Preliminary material should be accompanied by a statement identifying any substantial changes from previously filed material, with explanations which may assist the SEC examining staff.

Once the section 12(g) company files its preliminary proxy material, the SEC Corporation Finance Division will study the material

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is revocable; Item 2, A statement as to whether dissenters have rights of appraisal; Item 3, Identity of the persons making the solicitation; Item 4, A specification of any substantial interest of persons making the solicitation; Item 5, A specification of the voting securities and the principal holders thereof; Item 6, A statement whether there is to be an election of directors, an identification of nominees, and a specification of stock beneficially owned by them; Item 7, A statement as to remuneration, direct or indirect of officers and directors and a description of other transactions, if any, with management and with other interested persons; Item 8, A naming of the auditors, when the stockholders are asked to approve their designation; Item 9, A specification of any bonus, profit sharing or other remuneration plans; Item 10, A specification of any pension or retirement plans; Item 11, A specification of any options, warrants or rights; Item 12, A specification of any authorization or issuance of securities otherwise than for exchange; Item 13, A specification of any modification or exchange of securities; Item 14, Information if action is to be taken on any merger, consolidation or acquisition; Item 15, If action is to be taken on Items 12-14, a furnishing of financial statements of the issuer and its subsidiaries; Item 16, If action is to be taken on an acquisition or disposition of property, a furnishing of material information with respect thereto; Item 17, If any restatement of any asset, capital or surplus account, a furnishing of material information with respect thereto; Item 18, If any action with respect to any report of the issuer or its management, a furnishing of the material information thereto; Item 19, If any action is to be taken by stockholders on a matter not required to be submitted to them, a furnishing of material information thereto; Item 20, A specification whether any amendment of the charter, by-laws or other documents is to be taken and if so, a furnishing of material information thereto; Item 21, If action is to be taken on any other matter, a furnishing of material information thereto.

<sup>132</sup> 17 C.F.R. § 240.14a-4(b)(1) (1964).

<sup>133</sup> 17 C.F.R. § 240.14a-4(a) (1964).

<sup>134</sup> 17 C.F.R. § 240.14a-3(b) (1964).

<sup>135</sup> 17 C.F.R. § 240.14a-6(a) (1964).

<sup>136</sup> 17 C.F.R. § 240.14a-6(b) (1964).

and will, in most cases comment as to how the issuer can make a more complete disclosure.<sup>137</sup> Such comments may not be acceptable to the issuer, and counsel for the issuer must then work out some compromise acceptable to his issuer client and to the SEC, at which time amended material is filed. Two copies of all amended material filed should be marked in red to show changes. Only when the SEC has finally cleared the proxy solicitation material should the printing be commenced and the mailing made. Eight copies of all material in definitive form must be filed with the SEC home office concurrently with its distribution to security holders.<sup>138</sup>

A new section, 14(c), which has recently been implemented by regulation 14C, was added by the amendments.<sup>139</sup> In substance, section 14(c) provides that if proxies with respect to a security registered under section 12 are not solicited by management, then prior to any annual meeting or other meeting of such security holders, the issuer shall, in accordance with SEC rules and regulations relating to proxies, file with the SEC and transmit to all record holders information "substantially equivalent to the information that would be required if a solicitation were made."<sup>140</sup>

In recent amendments to the proxy rules the SEC, among other things, amended item 7(f) of schedule 14A. That item formerly required a description of any material interest, direct or indirect, of directors, officers, nominees for such offices and certain others in material transactions with the issuer or its subsidiaries. Such disclosure was only required if both the interest and the transaction were material. The amendment requires disclosure of a material interest of the insider in any transaction with the issuer or its subsidiaries, provided the amount involved in the transaction exceeds \$30,000; otherwise, no disclosure is required. The effect of this amendment eliminates the question as to whether the transaction is material.

## VI. SPECIAL PROBLEMS WITH SECTION 16

### A. *General Requirements*

Section 16(a) of the Securities Exchange Act provides, in substance, that a direct or indirect beneficial owner of more than ten per cent of any class of an equity security (except an exempt security) registered under section 12, or an officer or director (all of whom are referred to hereinafter as "insiders") of such issuer, "shall file"

<sup>137</sup> Printing of definitive material should not occur until the SEC's comments are received. 17 C.F.R. § 240.14a-6(h) (1964).

<sup>138</sup> 17 C.F.R. § 240.14a-6(c) (1964).

<sup>139</sup> 17 C.F.R. § 240.14(c) (1964) and regulation C, promulgated thereunder.

<sup>140</sup> 15 U.S.C. § 78n(c) (1964).

with the Commission, by the effective date of such registration statement, a report (form 3) showing the amount of all equity securities of such issuer which are owned by him. That section also requires such owner to up-date his filed report by filing a further report (form 4) "within ten days after the close of each calendar month thereafter" indicating any changes in such beneficial ownership which occurred in the preceding calendar month.<sup>141</sup> As noted above, rule 12b-5 provides that, for the purpose of section 16, securities are deemed registered when the registration statement becomes effective.<sup>142</sup>

Section 16(b) provides that the insider must relinquish to the issuer any profit realized by him from any purchase and sale, or any sale and purchase of any non-exempted equity security within any period of less than six months.<sup>143</sup> Securities "acquired in good faith in connection with a debt previously contracted" are excluded.<sup>144</sup> Section 16(b) specifically provides that the profit can be recovered through a suit instituted by the issuer, or, if for sixty days the issuer fails or refuses to bring such suit or to prosecute same diligently thereafter, any stockholder can bring it in the name and on behalf of the issuer. The two-year statute of limitations begins to run from the date when the "profit was realized."<sup>145</sup>

With regard to ten per cent beneficial owners, the section does not apply unless such owner was a ten per cent beneficial owner both at the time of the purchase and sale or the sale and purchase of the particular security involved. It should also be noted that section 16(c) prohibits short sales by insiders of all non-exempt securities.

While there can be little quarrel with the requirements of section 16(a) that insiders must report beneficial ownership of their issuer's securities (and any changes thereof), there have been, and will probably continue to be arguments and claims that section 16(b) is unfair, arbitrary and unreasonable and that it does not really accomplish the purpose for which it was intended. Section 16(b) is described by Louis Loss in his treatise as the "most cordially disliked provision" of all the securities laws.<sup>146</sup>

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<sup>141</sup> 15 U.S.C. § 78p(a) (1964). The SEC has expressed its opinion that the former item 7(f) did not in the past give adequate disclosure where insiders have had significant dealings with the issuer or its subsidiaries or have had significant interest in dealings between third parties and the issuer or its subsidiaries.

<sup>142</sup> 17 C.F.R. § 240.12b-6 (1964).

<sup>143</sup> 15 U.S.C. § 78p(b) (1964). Rule 16a-10 in substance provides that any transaction exempt from the reporting or filing requirements of § 16(a) is also exempt from the profit recovery provisions of § 16(b). 17 C.F.R. § 240.16a-10 (1964).

<sup>144</sup> 15 U.S.C. § 78p(b) (1964).

<sup>145</sup> 15 U.S.C. § 78p(b) (1964). Editor's Note: For such a view, see also in this Symposium, Lang & Katz, *Liability for "Short Swing" Trading in Corporate Reorganizations*, 20 Sw. L.J. 472 (1966).

<sup>146</sup> See 2 Loss, *op. cit. supra* note 8.

According to the testimony before the Senate Banking and Currency Committee, prior to the adoption of the Securities Exchange Act, section 16(b) was designed to "hold the directors, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing."<sup>147</sup> The outsider who purchases or sells a security does thereby receive some protection against the use of inside information by the insider during a period of six months or less. Since Congress was obviously adopting an objective test rather than a subjective one,<sup>148</sup> generally speaking it makes no difference, so far as the liability is concerned, whether there was or was not any actual use of inside information. If the purchase or sale of the security can be matched with any other sale or purchase of a security of the same class made within any six-month period, and, if a profit is realized, the insider is liable to pay such profit back to his corporation. The ideals of good faith, high-minded motivations or the best of intentions will afford the insider no defensive help. In the overwhelming number of instances, if he makes the prohibited trade, liability is a foregone conclusion.<sup>149</sup>

Furthermore, mere purchases and sales are not the only activities which must be reported. Every change in the beneficial ownership must be revealed, even though all purchases and sales during the month are equal. Thus, gifts, either to or from the insider, must be reported, since they change the amount of his beneficial ownership. Any transferable option, put, call, spread or straddle, either acquired or disposed of, is deemed such a change in beneficial ownership as to require the filing of the report.<sup>150</sup> Stock dividends, since they change the beneficial ownership, must be reported after the record date, although the receipt of the dividend is not a purchase for purposes of section 16(b). However, a pledge, generally speaking, does not result in a change of beneficial ownership and would not at the present time have to be reported until the pledgee is forced to fore-

<sup>147</sup> Mr. Thomas Corcoran, chief spokesman for the draftsmen and proponents of the act, in *Hearings before the Senate's Committee on Banking and Currency on S. 84, 72nd Cong., 2d Sess.; S. 56, S. 97, 73d Cong., 1st & 2d Sess., 1934, 6557.*

<sup>148</sup> *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir. 1943).

<sup>149</sup> *Ibid.*

<sup>150</sup> A put or a call is a form of option. A put is an option to sell a security to some person other than the issuer at some specified future date at a fixed pre-agreed-upon price. A call is an option to buy a security from a person other than the issuer at some specified future date at a fixed pre-agreed-upon price. See also SEC Securities Exchange Act Release No. 34-7793, Jan. 19, 1966.

close and sell the security pledged, at which time the pledgor must file a report indicating the change in his beneficial ownership.<sup>151</sup>

To comply with the filing requirement of section 16, the insider must initially file form 3 and up-date his beneficial ownership by the tenth day of the month following any changes thereon by filing form 4. Such forms must be timely filed, and there is no provision for obtaining from the SEC any extension of time in which to file. The important thing to remember is that until the form is filed, the two-year statute of limitations is tolled, even though the corporate officers and directors, who were in a position to bring the action, knew of the purchases or sales.<sup>152</sup> The commission has urged on numerous occasions that reports be timely filed, and they must be *received* at the SEC office by the tenth day of the month.<sup>153</sup> If an insider fails or omits to file a report through neglect or due to some misunderstanding as to his obligations, the best advice to give him is to file the report as soon as possible. The form can be signed by somebody other than, but on behalf of, the reporting person.

In filing a form 3 report, the insider must specify the nature of his beneficial ownership, if it is other than direct; and he may, if he so elects, state, in the form of a disclosure, that his filing shall not be construed as an admission that, for purposes of section 16, he is the beneficial owner.<sup>154</sup> Any explanation should appear on the form under "Remarks."<sup>155</sup>

For twelve months following their appointment and qualification, executors, administrators, guardians and the like are exempt from sections 16(a) and 16(b) as to securities held by them.<sup>156</sup>

Rule 16a-8 provides in substance that a trustee of a trust owning more than ten per cent of any class of an equity security must file the reports required by section 16. The rule also defines beneficial ownership so far as the trust is concerned and permits a beneficiary of the insider trust to rely in good faith upon an understanding that the trustee will file the report. Only one report need be filed which discloses the names of all trustees, settlors or beneficiaries who are insiders.<sup>157</sup>

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<sup>151</sup> SEC Securities Exchange Act Release No. 34-7795, Jan. 20, 1960.

<sup>152</sup> *Grossman v. Young*, 72 F. Supp. 375, 378 (S.D.N.Y. 1947); *cf. Fistel v. Christman*, 13 F.R.D. 245 (W.D. Pa. 1952).

<sup>153</sup> SEC Securities Exchange Act Release No. 34-5845, Jan. 6, 1959; *Archie H. Chevrier*, SEC Securities Exchange Act Release No. 34-7579 (1965).

<sup>154</sup> 17 C.F.R. § 240.16a-3 (1964).

<sup>155</sup> See instruction on reverse of forms 3 and 4 prepared by the Securities and Exchange Commission for use by corporate insiders complying with filing requirements of 15 U.S.C. § 78p(a) (1964).

<sup>156</sup> 17 C.F.R. § 240.16a-4 (1964).

<sup>157</sup> 17 C.F.R. § 240.16a-8 (1964).



### B. *Beneficial Ownership*

Beneficial ownership is acquired or divested at the time when a firm commitment for the purchase and sale is made. If certain conditions must still be performed before the transaction is consummated, and if it is not certain that such conditions will be performed, then the beneficial ownership is neither acquired nor divested until such conditions are performed and the contract does become a firm commitment.<sup>158</sup>

Whether a husband is the beneficial owner of securities held in his wife's name has in the past depended on whether as a factual matter there existed between them any "contract, understanding, relationship, agreement or other arrangement" by which he possessed "benefits substantially equivalent to those of ownership." If the husband has the power to invest or reinvest the full legal and equitable title in himself at once or at some future time without payment or other than a nominal consideration, he would appear to be the beneficial owner.<sup>159</sup>

In a recent release the Securities and Exchange Commission made the determination that generally "a person is regarded as the beneficial owner of securities held in the name of his or her spouse and their minor children" because such person derives income benefits from such ownership. Therefore, a person should include in his forms 3 and 4 filed pursuant to section 16(a) "securities held in the name of a spouse or minor children as being beneficially owned by him." The release goes on to suggest that if special circumstances such as divorce or legal separation exist, the party claiming the absence of beneficial ownership should present the facts to the SEC in Washington, D.C., and request an opinion as to whether such securities should be reported or not.<sup>160</sup>

On January 20, 1960, the SEC issued Securities Exchange Act Release No. 34-7795 in which it was proposed that additional information be disclosed in forms 3 and 4 with respect to certain changes in "beneficial ownership" involved in "the acquisition or disposition of certain puts, calls, options, etc. or the making of pledges or loans of securities. . . ." No action has as yet been taken with respect to these forms.

Changes in indirect beneficial ownership of an equity security must

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<sup>158</sup> SEC Securities Exchange Act Release No. 34-116, March 9, 1935, 11 Fed. Reg. 10967 (1965).

<sup>159</sup> *Ibid.*

<sup>160</sup> SEC Securities Exchange Act Release No. 34-7793, Jan. 19, 1966, 31 Fed. Reg. 1005 (1966).

also be shown in form 4.<sup>161</sup> Such indirect ownership exists, for example, when the direct ownership of a particular security is in a corporation, partnership, trust or other comparable entity which is used as a "medium through which one person, or several persons in a small group, invest or trade in securities and when such entity has no other substantial business." If a person were in control of a holding company and also an insider of an issuer of securities held by the holding company, such person would have to report as indirect beneficial owner of the securities held by the holding company.<sup>162</sup>

If an insider is in doubt as to whether to file or as to whether the requisite ownership exists, the report should be filed and perhaps a disclaimer of beneficial ownership should also be made in the filing.<sup>163</sup>

### C. Who Must File Reports Under Section 16

As defined by section 3 (a) (7) of the Securities Exchange Act, the term "director" includes anyone performing similar functions to those performed by a director.<sup>164</sup>

An officer is defined by rule 3B-2 to mean "a president, vice-president, treasurer, secretary, comptroller, and any other person who performs for an issuer . . . functions corresponding to those performed by the foregoing officers."<sup>165</sup>

In *Colby v. Klune*,<sup>166</sup> the Second Circuit did not accept in its entirety the commission's rather objective definition of an officer, and the court suggested that a broader, more subjective test should be applied to include an officer who was performing executive duties which would give him access to inside information which he might be able to use unfairly. In a later case, *Lockheed Aircraft Corp. v. Rathman*,<sup>167</sup> a district court in another circuit did not go along with *Colby v. Klune* decision but instead applied the SEC's objective officer test.

The SEC, in an early General Counsel's opinion, discussed the liability of corporate assistants pursuant to the coverage of sections 16(a) and 16(b). It was concluded that an assistant officer, such as an assistant vice-president, assistant secretary or an assistant treasurer, will be subject to sections 16(a) and 16(b) only if his chief is inactive over such a substantial period of time during which the assistant is in fact performing the duties and functions of his chief.

<sup>161</sup> See instructions Nos. 9 and 10 to form 4.

<sup>162</sup> See SEC Securities Exchange Act Release No. 34-1965, Dec. 21, 1938, 11 Fed. Reg. 10967 (1965).

<sup>163</sup> 17 C.F.R. § 240.16a-3 (1964).

<sup>164</sup> 15 U.S.C. § 78c(a)(7) (1964).

<sup>165</sup> 17 C.F.R. § 240.3b-2 (1964).

<sup>166</sup> 178 F.2d 872 (2d Cir. 1949).

<sup>167</sup> 106 F. Supp. 810 (S.D. Cal. 1952).

With this exception, assistants generally are not subject to section 16.<sup>168</sup> Whether a "division" officer will be subject to the provisions of section 16 will perhaps depend on his duties rather than the title he has. In a situation where a well-known manufacturing concern merges into a little-known, non-operating company and where the president of the former becomes a mere division president but the entire business of the parent becomes the manufacturing business of the subsidiary, there may well be a question, assuming such a company to be a section 12 (g) company, as to whether or not the division president is an officer who has to report under section 16 (a) and be subject to the provisions of 16 (b).

Another requirement which should be clearly understood is that the insider of a section 12 (g) company must include in his section 16 (a) report (form 3 or form 4) the "amount of all equity securities of such issuer," not just the amount of those securities which are registered. Thus, if under section 16 (b) the insider makes a profit in purchase and sale transactions consummated within a six-month period with respect to a preferred stock of a class with less than 500 shareholders, where the common stock is registered, the insider may be liable to disgorge the profit made in the preferred stock transactions.<sup>169</sup>

The definition of an "equity security" is quite broad and includes, in addition to "stock or similar security," any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right.<sup>170</sup> Any other security which the SEC may prescribe by rule to treat as a security is also included.<sup>171</sup> The purchase and sale which are matched do not, of course, have to be of identical certificates of the same class.<sup>172</sup> As noted earlier in this Article, securities will be deemed to be of the same class if they "are of substantially similar character" and if the holders "enjoy substantially similar rights and privileges."

The last sentence of section 16 (b) states that the "subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase of the security involved." Despite the apparent clarity of

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<sup>168</sup> SEC Securities Exchange Act Release No. 34-2687, Nov. 16, 1940, 11 Fed. Reg. 10967 (1965).

<sup>169</sup> See 15 U.S.C. § 78p (1964).

<sup>170</sup> For a more complete discussion see also in this Symposium, Lang & Katz, *Liability for "Short Swing" Trading in Corporate Reorganizations*, 20 Sw. L.J. 472 (1966).

<sup>171</sup> See 17 C.F.R. § 240.3a11-1 (1964).

<sup>172</sup> Note 148 *supra*.

this provision, the court in *Stella v. Graham-Paige Motors Corp.*<sup>173</sup> counted the transaction in which the stockholder became the ten per cent beneficial owner. However, the court in *Arkansas Louisiana Gas Co. v. W. R. Stephens Inv. Co.*<sup>174</sup> did not count that last transaction. If the Second Circuit's decision is the correct one, because it better "effectuates the legislative purpose" in view of the statutory "ambiguity," then the transaction by which a ten per cent beneficial owner divests himself of such ownership should also be counted.

The statute does not say that officers and directors have to be such at both ends of the transactions. It does seem clear, however, that from the time a person first becomes an officer or a director of a section 12(g) company, any purchases or sales which he effectuates in his company's securities will be matched with any sales or purchases that occurred in the preceding six months, even though he was not then an officer or director.<sup>175</sup> This rule is of great significance for persons who are about to be, or have recently been, elected officers or directors of a section 12(g) company. While there may be some question as to whether a sale by an insider made before registration can be matched with a purchase made after registration, because no profit has been realized by the insider in a *registered* security, the fact is that courts in section 16(b) cases are prone to find a way to award maximum profits against the insider involved.<sup>176</sup>

There is no question, after the *HeliCoil case*,<sup>177</sup> that a purchase made prior to registration can be matched with a sale made afterwards, since the profit realized is certainly realized after the obligation to file the section 16(a) report has been incurred. Finally, it is clear that transactions which occur after de-registration are not subject to section 16(b), because there then exists no obligation to file section 16(a) reports.

Section 12(h), among other things, does permit the SEC:

by rules and regulations or upon application of an interested person, by order, after notice and opportunity for a hearing, . . . [to] exempt from section 16 any officer, director, or beneficial owner of securities of any issuer, any security of which is required to be registered . . . upon such terms and conditions and for such period as it deems necessary or appropriate, if the Commission finds, by reason of the number

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<sup>173</sup> 232 F.2d 299 (2d Cir. 1956).

<sup>174</sup> 141 F. Supp. 841 (W.D. Ark. 1956).

<sup>175</sup> *Perfect Photo, Inc. v. Grabb*, 205 F. Supp. 569 (E.D. Pa. 1962); *HeliCoil Corp. v. Webster*, 222 F. Supp. 831 (D.N.J. 1963).

<sup>176</sup> See *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir. 1947); *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir. 1954); *Stella v. Graham-Paige Motors Corp.*, 232 F.2d 299 (2d Cir. 1956).

<sup>177</sup> Note 175 *supra*.

of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors.<sup>178</sup>

While this provision has not as yet been used, several exemptions have been specifically provided. Rule 16a-10 exempts from section 16(b) any transaction which is exempt from section 16(a).<sup>179</sup> Rule 16b-1 and rule 16b-4 exempt transactions by registered investment companies and public utility holding companies, respectively, where the transactions have been previously approved or permitted by the SEC pursuant to applicable provisions of other regulatory acts.<sup>180</sup> Rule 16b-2 exempts purchases and sales by underwriters in a distribution.<sup>181</sup> Rule 16b-3 exempts the acquisition of stock acquired pursuant to a stock bonus or similar plan, and stock options acquired pursuant to a qualified or restricted stock option plan, provided the plan meets certain clearly specified conditions.<sup>182</sup> The theory of this rule is that unless exempt, the annual receipt by insiders of stock pursuant to a stock bonus plan adopted by his company would subject such insider to constant section 16(b) liability for any sale he made. Since the *Green v. Dietz* decision,<sup>183</sup> and *Perlman v. Timberlake*,<sup>184</sup> the exemption applies to the acquisition of the stock option, warrant, or right but not to the exercise and acquisition of the underlying common stock. In those cases, an early SEC rule which exempted the acquisition of the stock or exercise of the option was questioned, and the SEC subsequently withdrew that rule.

Rule 16b-6 exempts long-term profits incident to sales within six months of the exercise of an option.<sup>185</sup> Rule 16b-5 exempts certain transactions in which securities are received by redeeming other securities.<sup>186</sup> Rule 16b-7 exempts certain acquisitions and dispositions of securities pursuant to mergers or consolidations.<sup>187</sup> Rule 16b-8 exempts certain securities received upon surrender of similar equity securities.<sup>188</sup> Rule 16b-9 exempts certain transactions involving an exchange of similar securities.<sup>189</sup>

<sup>178</sup> 15 U.S.C. § 78l(h) (1964).

<sup>179</sup> 17 C.F.R. § 240.16a-10 (1964).

<sup>180</sup> 17 C.F.R. § 240.16b-1 (1964) and 17 C.F.R. § 240.16b-4 (1964).

<sup>181</sup> 17 C.F.R. § 240.16b-2 (1964).

<sup>182</sup> 17 C.F.R. § 240.16b-3 (1964).

<sup>183</sup> 247 F.2d 689 (2d Cir. 1957).

<sup>184</sup> 172 F. Supp. 246 (S.D.N.Y. 1959).

<sup>185</sup> 17 C.F.R. § 240.16b-7 (1964).

<sup>186</sup> 17 C.F.R. § 240.16b-5 (1964).

<sup>187</sup> 17 C.F.R. § 240.16b-7 (1964).

<sup>188</sup> 17 C.F.R. § 240.16b-8 (1964).

<sup>189</sup> 17 C.F.R. § 240.16b-9 (1964).

Because the above exemptions relate to technical or specialized types of transactions, a party seeking to utilize one of them must study the particular provision with a full appreciation that he who claims the exemption has the burden of proving its applicability.

#### D. *What Is A Purchase Or A Sale?*

A bona fide gift is not a sale, and, regardless of whether the gift was made by an insider or to an insider, the gift for purposes of either section 16(a) or 16(b) does not count as a sale by the donor or a purchase by the donee.<sup>190</sup> Any subsequent sale by the donee within six months of the gift probably does not give rise to section 16(b) liability. This result is not to be confused with the SEC practical requirement that charitable gifts of securities made by insiders to support a specific purpose requiring cash must be registered under the Securities Act of 1933 before the charity can sell the shares to the public.<sup>191</sup>

Warrants or options to purchase stock constitute another complex area involving purchases and sales. Many factors must be considered. For example, a transferable option becomes a purchase when it is exercised; stock options issued in compliance with section 421 of the Internal Revenue Code must be non-transferable; the actual exercise of an option is considered a purchase of the security for which the option was given.<sup>192</sup> However, the issuance of warrants, across the board, to all stockholders for some corporate purpose such as satisfying pre-emptive rights, does not constitute a purchase by the insider under either section 16(a) or section 16(b).<sup>193</sup> By contrast, when the warrants are received by the insider alone, or by the insider along with a few others, and not by the stockholders generally, the warrants, although purportedly "given for free," are considered purchases as of the time of their receipt by the insider.<sup>194</sup>

Generally speaking, stock acquired or disposed of by way of a statutory merger or through consolidation or acquisitions of corporate assets are considered to be purchases or sales, depending on which side of the transaction the insider is located. Such transactions are therefore subject to the reporting requirements of section 16(a) and the disgorgement provisions of section 16(b).<sup>195</sup> Before a merger, con-

<sup>190</sup> *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948); *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir. 1949).

<sup>191</sup> An example is Ford and the Ford Foundation.

<sup>192</sup> 15 U.S.C. § 77b(3) (1964).

<sup>193</sup> *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir. 1949).

<sup>194</sup> *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948).

<sup>195</sup> See *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951). For a more complete discussion see also in this Symposium, Lang & Katz, *Liability for "Short Swing" Trading in Corporate Reorganizations*, 20 Sw. L.J. 472 (1966).

solidation or acquisition is consummated between two section 12 (g) companies or between a section 12 (g) company and some other company, care must be taken so that the insiders will not be faced with suits requiring them to dispose of all profits realized by them in the transaction.

## VII. CONCLUSION

As may well be expected when a comprehensive body of law is applied for the first time to a large number of existing commercial enterprises, many problems will necessarily be faced by what we have referred to as section 12 (g) companies. The crucial function of alert practitioners must be one of placing officers, directors and ten per cent stockholders on notice of the numerous problems we have outlined. New factual situations will present problems which must be resolved in light of the 1964 amendments and the Commission's rules and regulations promulgated thereunder, but such resolutions are possible only once the dilemma has been recognized.