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ACQUISITIONS UNDER THE FEDERAL SECURITIES ACTS—A PROGRAM FOR REFORM

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I. THE PROBLEM

The disclosure system under the Securities Act of 1933 [1] and the Securities Exchange Act of 1934 [2] works badly with respect to acquisition transactions in which one company issues its stock to acquire another. Reform in this area of the law is sorely needed. Not only are there difficulties with the substantive law, but there is also an intolerable lack of certainty as to what the substantive law is. Some of the recurring problems may be illustrated by the following example, which is patterned substantially on cases which have arisen in my own practice.

A giant company, G Co., with stock listed on the New York Stock Exchange, acquired a privately held family company, F Co. The stock of F Co. was held by the F family as follows:

Older Brother	60%
Younger Brother	25%
Wives and children of the brothers (some of the children being adults and some being minors whose stock was held by the parents as fiduciaries)—a total of eight separate accounts	10%
Five employees (two of whom were directors) who acquired their shares by the exercise of qualified stock options just before the acquisition became effective	5%
	100%

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[1] 15 U.S.C. §§ 77a-bbb (1964 and Supp. II, 1966).

[2] 15 U.S.C. §§ 78a-jj (1964).

The transaction took the form of an exchange of G stock for F's assets, pursuant to a vote of F Co. stockholders. F Co. received 300,000 G Co. shares, equal to ten per cent of the G Co. stock outstanding after the acquisition. Following the closing, F Co. was dissolved and the G Co. stock was distributed pro rata to the F. Co. stockholders.

The F family wanted to sell one-third of their G Co. stock immediately after the transaction and to hold two-thirds of their G Co. stock for long-term investment. Pursuant to its contractual obligation, G Co. registered the stock which it issued in the transaction. The registration statement indicated that the stock would be pledged, or sold by the F Co. stockholders from time to time on the New York Stock Exchange or in negotiated transactions at prices related to the prevailing market price at the time of sale.

Following the acquisition, Older Brother was elected a director of G Co., but died within three months, never having attended a G Board meeting.

Let me identify some of the legal questions in this not too unusual case[3]—questions about which considerable doubt existed among very knowledgeable attorneys.

Does Rule 133 Apply? Rule 133, under the Securities Act of 1933, embodies the so-called "no-sale" exemption.[4] Simplifying the highlights of the rule, it typically applies to acquisitions accomplished by virtue of a stockholder vote of the acquired company—mergers or stock-for-assets acquisitions, but not stock-for-stock acquisitions. The rule provides, in substance, that the issuance and transfer of stock by the acquiring company in an acquisition covered by the rule does not constitute a "sale" under the registration provisions of the 1933 Act. It is the rationale of the rule that the change in the form of the investment held by the acquired company's stockholders is a result of "corporate" action and not a result of their individual consent.

In a transaction covered by the rule, the stock of the acquiring company which is received by *non-controlling* stockholders of the

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[3] The example in the text is actually a composite of several cases, with facts slightly altered, which have arisen in my own practice. Thus, it is not based on imaginary horrors, but on a series of problems actually encountered by one practitioner within the relatively recent past, a point worth noting in appraising the need for reform in this area of the law.

For a humorous exposition of the problem areas covered by this article, especially the fungibility doctrine, the change of circumstances doctrine, and the effect of a merger on an investment holder, see Kennedy, *The Case of the Scarlet Letter*, 23 BUS. LAW. 23 (1967).

[4] SEC Rule 133, 17 C.F.R. § 230.133 (1968) [hereinafter cited as rule 133], is set forth in full as an appendix to this article. The summary in the text is incomplete. Many of the refinements are considered elsewhere in the article.

acquired company may be sold freely by such stockholders in the public market without registration under the Act. The stockholders who are *in control* of the acquired company may sell, in routine brokerage transactions, small amounts of the acquiring company's stock that they receive, but must register their shares for sales which exceed the limits of the leakage formula contained in the rule. The numerical limit on the brokerage sales of securities traded over the counter, which may be made without registration, is one per cent of the number of shares outstanding of the class involved. For exchange-traded securities, the limit is the lesser of this number or the largest aggregate reported volume of trading on securities exchanges during any week within the four preceding weeks.

Although G Co.'s acquisition of F Co. fit within the wording of rule 133, the initiated know of an administrative gloss, the "negotiated transaction" exception. If one or a very few persons own all of the stock of an acquired company, the SEC sometimes takes the position that rule 133 does not apply, arguing that the transaction was accomplished by "negotiation" and not by virtue of action of the corporate body.[5] Thus, if one man owns all of the acquired company's stock and he negotiates the transaction, rule 133 is inapplicable. However, if one man owns ninety per cent of the stock and ten minority

[5] The negotiated transaction exception as stated in the text above represents a version recently given me by an authoritative source at the Commission. There seems to be a modified view among other SEC staff members who apply the exception where one or a very few shareholders hold the voting power necessary to consummate the transaction, notwithstanding the existence of some minority shareholders who did not participate in the negotiations. However, the modified view is applied in cases involving closely held companies, and apparently is not applied where a limited group holds overwhelming voting power in a public company.

The negotiated transaction doctrine was articulated by the SEC as an exception to the pre-1959 version of the rule, before subsections (d) and (e) were added expressly permitting limited resale of the acquiring company's stock by the acquired company's stockholders. *E.g.*, Great Sweet Grass Oils, Ltd., 37 S.E.C. 683 (1957), *aff'd per curiam*, 256 F.2d 893 (D.C. Cir. 1958). It was generally assumed that the 1959 amendment undercut the rationale of the negotiated transaction doctrine, and effectively eliminated it. 1 L. Loss, SECURITIES REGULATION (2d ed. 1961) [hereinafter cited as Loss]. I have not discovered any post-1959 formal statement of the Commission relying on the doctrine, although the staff is using it informally—for example, in discussing no-action requests.

Nothing in the SEC'S stated rationale when the rule took its current form in 1959 would justify the continued application of the negotiated transaction exception to the rule. Indeed, the Commission's explanatory release proposing the rule's present format suggests that the negotiated transaction exception is no longer viable. It rejected the argument that transactions covered by the rule do not involve a "sale" for any purpose under the Act. In so doing, it stressed the fact that *all* transactions covered by the rule "are basically contractual in their foundation, reflecting essentially contractual relationships among security holders and between security holders and corporations." *See* Securities Act Release No. 3965 (Sept. 15, 1958). If mergers with one-man corporations are to be exempted from the rule, it should be on the theory that certain relationships (*e.g.*, between the stockholder and his own corporation) are *not* negotiated—that is, they are not contractual—relationships. On the other hand, this analysis may prove simply that the commonly used expression "negotiated transaction" is an awkward way to express the concept underlying the exception to the rule. For a detailed history of the rule, see 1 Loss 518-42.

holders, who do not participate in the negotiations, own the balance, the rule does apply. The critical test seems to be whether there are *any* stockholders, however small their holdings, who did not participate in the negotiations and who, therefore, are bound by the corporate action (subject only to the availability of appraisal rights).

There are a number of lawyers who advise clients as though the negotiated transaction doctrine did not exist. Among these lawyers, the unsophisticated have not discovered the doctrine—and the highly sophisticated do not believe in it. To the sophisticates, the negotiated transaction exception is so at variance with the express provisions of the present rule 133, especially in light of its history,[6] that no court would apply the doctrine as a limitation on the rule itself.

In the acquisition of F Co., there were 13 F Co. shareholders in addition to the two brothers who participated in the negotiations with G Co. However, eight of these were immediate family members of the brothers and, by another administrative interpretation, a man owns beneficially the shares held by members of his immediate family.[7] There were five other stockholders of F Co., the optionees who held a small portion of the shares. But their shares were acquired in contemplation of the merger. It is debatable whether the creation, on the eve of the closing, of new stockholders who did not participate in the negotiations, would suffice to avoid the application of the negotiated transaction exemption exception to the no-sale rule.

Who Was in "Control"? If rule 133 applies, it is (generally speaking) only the controlling stockholders of F Co. who would be restricted in the resale of their G Co. stock.[8] Some would argue that Older Brother was the sole controlling person, since he held, directly in his own name, an absolute majority of the F Co. stock. On the other hand, many would say that the two brothers together constituted the control group, while at the opposite extreme, others would maintain that all F family members were in joint control. There may even be support for the theory that the two optionee-directors were part of the

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[6] *See* note 5 *supra*. While the sophisticates may not ignore the negotiated transaction exception in major acquisitions (*e.g.*, where the acquired company has only one shareholder), they will render opinions that rule 133 applies in grey-area cases, knowing that the SEC staff would probably decline to give a favorable no-action position if asked. Even if a court were to sustain the staff's view that the exception applied (and therefore the rule did not), a client relying in good faith on the terms of the rule as written should be protected against liability by Securities Act of 1933 § 19(a), 15 U.S.C. § 77s(a) (1964).

[7] SEC Securities Exchange Act Release No. 7824 (Feb. 14, 1966); Shreve, *Beneficial Ownership of Securities Held by Family Members*, 22 BUS. LAW. 431 (1967). It is questionable whether this doctrine applies to married children living separately.

[8] *See* rule 133(c)-(f). *But see* note 72 *infra*.

control group, since the brothers exercised control "through" the optionee-directors, whatever that may mean.[9]

How Many Individuals May Sell the Number of Shares Permitted by Rule 133? The rule provides, in effect, that "a person" who was in control of the acquired company may sell stock of the acquiring company (up to specified limits) in routine brokerage transactions within a six-month period. However, just because a warm body has a head, four limbs and all the customary anatomical features, there is no assurance in a particular case that such a body, standing alone, will constitute "a person" under rule 133. Under another SEC gloss, some lawyers feel that the entire F family is one "person," [10] while others would view each brother, together with his wife and children, as a separate "person." [11]

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[9] In a recent case, the SEC reached the extraordinary conclusion that *all* 19 stockholders of a corporation were "members of a control group" since *"most* . . . were united by family, personal or business ties and acted in concert with *or acquiesced in the actions of* [the dominant party] as their leader." Strathmore Securities, Inc., SEC Securities Exhange Act Release No. 8207, at 6 (Dec. 13, 1967) (emphasis added). See generally, Sommer, *Who's "In Control"?—S.E.C.*, 21 BUS. LAW. 559 (1966).

I do not believe that the implications of *Strathmore*—that mere acquiescence by a minority stockholder in the domination of another person places the minority shareholder in a control status—need be taken too seriously. Otherwise, any passive stockholder, not in active opposition to management, would share a control status.

Some SEC opinions state many grounds for reaching a conclusion. One often feels that the primary reasons relied upon by the SEC are far more convincing than the secondary points which are apparently thrown in for good measure. It was clear for other reasons in *Strathmore* that rule 133 was inapplicable to the sales in question, and the section of the opinion quoted above appeared in just such a "Moreover . . ." paragraph.

[10] In Strathmore Securities, Inc., SEC Securities Exchange Act Release No. 8207 (Dec. 13, 1967), the Commission indicated that the entire control group was a single "person" for purposes of rule 133(d), and that sales by all individuals within the group had to be lumped together in applying the 1% test. In my view the authorities cited by the Commission in this case do not support its conclusion. The releases which it cited, SEC Securities Act Release No. 4669 (Feb. 17, 1964), and SEC Securities Act Release No. 4818 (Jan. 21, 1966) (both of which deal with SEC rule 154, 17 C.F.R. § 230.154 (1968), which parallels rule 133), have generally been interpreted to mean that all sales by members of a control group should be lumped only if the controlling persons are *acting in concert* to cause a *group distribution,* but not necessarily to mean that all such sales must be combined merely because they occur in the same six-month period. The other cases cited by the SEC in *Strathmore* suggest that "control" may be vested in a group of persons acting in concert, but otherwise are not in point because they do not deal with the issue of who constitutes a "person" under either rule 133 or rule 154. It is often unclear when rule 133 interpretations can be applied to rule 154, and vice versa. However, with respect to the problem of who constitutes a "person," the SEC's interpretative release on rule 154 has a footnote stating that "A similar problem exists under Rule 133 . . ." SEC Securities Act Release No. 4818, at 2 n.2 (Jan. 21, 1966).

[11] I would guess that this view represents the current opinion of the majority or at least a respectable minority of experienced practitioners. *But cf.* Kennedy, *The Case of the Scarlet Letter,* 23 BUS. LAW. 23, 26 (1967). A good many lawyers would advise that each brother, together with his own wife and children, is a "person" separate from the other brother's immediate family group. Even within this school of thought there is disagreement whether married children must be lumped with their parents. *Cf.* note 7 *supra.*

May a Controlling Shareholder Sell Up to the Limit in Successive Six-Month Periods? Note that Older Brother could sell one third of his six per cent,[12] or two per cent, within a one-year period, if the rule permits a maximum sale in successive periods. While this delay of one year would have been acceptable to Older Brother, he must take into account still another administrative interpretation, which says that the rule is designed only for occasional or isolated sales and does not include a preconceived plan to sell up to the maximum amount in successive six-month periods.[13]

What About the Optionees? The optionees acquired their F Co. stock "for investment." An investment holder may sell his stock, notwithstanding his investment intent, if there has been an unanticipated or unforeseen change in circumstances, and a merger of the company issuing the investment stock into a much larger company would normally constitute such a change of circumstances under this doctrine.[14] However, these optionees bought their F Co. stock in contemplation of the pending merger, so they can hardly call the merger an unanticipated event. Must they hold their G Co. stock for investment?

Some lawyers believe that the investment status carries over to shares of the acquiring company which are issued in a rule 133 transaction to a non-controlling person of the acquired company in exchange for investment shares of the latter company.[15] In my view, however, such an overly cautious approach does too much violence to the lan-

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[12] As noted above, Older Brother owned 60% of F Co., and the F stockholders as a group received 10% of the outstanding G Co. stock, so that Older Brother received 6% of the total number of shares outstanding.

Since Older Brother became a director of G Co., any sale of his G Co. stock within 6 months of his purchase of such stock (the acquisition being a "purchase" for this purpose), might create a short-swing profit recoverable by G Co. under the Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1964). This factor might well lead Older Brother to defer his sales.

[13] The Commission so interprets rule 154. SEC Securities Act Release No. 4818 (Jan. 21, 1966). On this point, a significant number of lawyers feel that this restrictive rule 154 interpretation should not (does not?) apply to the rule 133 situation. Possibly they make the instinctive judgment that a non-controlling, rule 133 seller should be entitled to a more generous leakage provision than the controlling person relying on rule 154.

[14] The Act does not refer to purchases "for investment." The term is generally used to refer to the status or state of mind of a purchaser in an exempt "private offering," *i.e.*, a transaction "not involving any public offering" within the meaning of Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1964). A purchase "for investment" means that the purchaser does not become an "underwriter," an "underwriter" being a purchaser who takes "with a view to . . . distribution" within the meaning of Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1964). *See generally* SEC Securities Act Release No. 4552 (Nov. 6, 1952). *See also,* regarding changes of circumstances, text accompanying note 42 *infra.*

[15] It has been reported that the Commission staff takes this position "from time to time." WHEN CORPORATIONS GO PUBLIC 29-30 (C. Israels & G. Duff, Jr. eds. 1962). *But see* Kennedy, *The Case of the Scarlet Letter,* 23 BUS. LAW. 23, 31 (1967).

guage of the rule, and would not be sustained by a court in the normal circumstances of a bona fide arm's-length transaction. It would be totally anomalous to place the optionees in a worse position than the F brothers. However, it must be acknowledged that such anomalies do exist under rule 154, and some lawyers believe that the rule 154 theology carries over to rule 133 transactions.[16]

Does Older Brother's Death Amount to an Unanticipated Change of Circumstances[17] *Freeing His Stock for Sale Without the Need for Registration?* Can death, along with taxes the most certain of all life's eventualities, ever be an *unanticipated* change of circumstances for this purpose? Would it matter if F family sold its business because of Older Brother's advanced age and failing health? The change of circumstances doctrine is well established[18] and a death is normally considered a change for this purpose. Is it not unfortunate from the policy point of view, however, to have the need for registration turn on a factor such as a change in the individual circumstances of a single stockholder?

In view of the considerations mentioned above, it was decided that the shares should be registered. This decision, in turn, raised certain further questions.

How Many Shares Should Be Registered, and How Should the Plan of Distribution Be Described? Should the registration statement cover 100,000 shares, representing the third which the family took for sale, or the full 300,000 shares? Since the acquisition agreement indicated that one-third of the shares were taken for sale, may the transaction be split? Can it be said that 200,000 shares were taken "for investment"—with the result that 200,000 shares may be sold without registration in the circumstances (whatever they may be) under which investment stock is normally salable? Or must the

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[16] Rule 154 defines "brokers' transactions." Although it has a statutory setting different from rule 133, both rules contain a similar 1% leakage provision, and many interpretive positions are applied equally to the two rules. *See* SEC Securities Act Release No. 4818 (Jan. 21, 1968).

As the SEC interprets rule 154, it may permit the president and controlling stockholders to sell enormous blocks in routine brokerage transactions; however, the rule's leakage provisions are unavailable to a minor executive who buys a few unregistered shares for investment on the exercise of an option and who wants to sell his option shares in routine brokerage transactions shortly after they were acquired. The "fungibility" doctrine, sometimes applied, adds insult to injury. If an employee buys option shares for investment, he may not concurrently sell other shares acquired on option exercises many years ago. In fact, his current option exercise for investment may even restrict the sale of shares bought years ago on the open market.

[17] See text accompanying notes 46-47 *infra.*

[18] *See, e.g.,* SEC Securities Act Release No. 4552 (Nov. 6, 1962).

acquisition be viewed as a unified transaction which does involve a public offering, leaving none of the shares with an investment status? [19]

Assume that the F family wanted the benefits of a "shelf" registration [20] for the 200,000 shares. Or, alternatively, assume that counsel believed such registration was required, since the transaction as a whole did involve a non-exempt public offering by statutory "underwriters." How should the plan of distribution be described in the prospectus? How should G Co. complete Item 26 in Part II of the Form S-1 [21] registration statement, which must describe recent sales of unregistered securities? The typical shelf registration statement indicates that the shares "may be sold from time to time." Such disclosure is hardly very informative to the market analyst who wants to evaluate the selling pressure to be expected in the market.

What Should Be Included in the Prospectus About Transactions Between F Co. and the F Family? The prospectus must describe transactions between the company issuing the registered shares and its management over the three years prior to filing.[22] Older Brother had been a director of G Co., however fleetingly, before his death. The F business was now part of the consolidated enterprise.

Since the lawyers were unwilling to run the risk of a material omission, they felt it necessary to include in the prospectus a detailed recital of transactions between the F family and F Co. for the prior three years, even though most of such relationships terminated with the acquisition itself.[23] It took weeks of intensive effort to reconstruct the data.

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[19] As a general proposition, the Commission will not ordinarily allow a transaction to be split in order to establish an exemption. *Cf.* SEC Securities Act Release No. 4434 (Dec. 6, 1961); SEC Securities Act Release No. 3825 (Aug. 12, 1957). Under this interpretation, registration of the full 300,000 shares would be required. However, Securities Act of 1933, § 6(a), 15 U.S.C. § 77f(a) (1964), states that "A registration statement shall be deemed effective only as to the securities specified therein *as proposed to be offered*" (emphasis added). Under its customary interpretation of this provision, the Commission might have considered it improper to register the 200,000 shares which the family expressly intended to retain.

The Commission does make certain exceptions, however, to the doctrine that a transaction cannot be split. Thus, if a distribution of securities involves a public offering outside of the United States and a simultaneous private placement within this country, the Commission will, under certain circumstances, relax the integration doctrine and treat the domestic portion of the offering as an exempt private offering. SEC Securities Act Release No. 4708 (July 9, 1964).

[20] "Shelf" registration refers to certain deferred or contingent offerings which are registered but are not underwritten for immediate public sale in the conventional manner. It implies that the registered shares, like inventory on the shelf, are available for public sale. Registration of outstanding shares that may be sold from time to time by the present stockholders is a form of shelf registration.

[21] 17 C.F.R. § 239.11 (1968).

[22] Form S-1, Item 20, 17 C.F.R. § 239.11 (1968).

[23] The question was raised with the SEC staff whether it was necessary to disclose these prior dealings. The initial staff response was equivocal and counsel could not obtain a clear-cut, no-action position. The point was not pressed, since a favorable staff opinion would not in any event have given insulation against potential civil liability arising out of a material omission.

A Horror of Horrors: Suppose the F Family Does Not Sell All of the Registered Shares Before the Prospectus Information Becomes Stale? If the filing of the registration statement manifests an intent to sell 100,000 shares (or even the full 300,000 shares), does this mean that the registered shares may never be sold without a current prospectus, no matter how deferred the sale? The problem would be most acute if the number of shares sold under the original prospectus was not exactly one third. Since one third of the shares were taken with the express purpose of public sale, the holders would have an "underwriter" status as to any of the first 100,000 shares which remained unsold.[24] On the other hand, if more than 100,000 shares were sold in the initial period, it would mean that the 200,000 share "investment" block had been invaded, which could destroy the "investment" status of the remainder of the 200,000 share block.

Variations on this basic question arise frequently—whenever an investment holder has a chance to register and sell investment shares. The investment holder faces an uncomfortable dilemma. He must run the risk that the sale of a portion of his investment shares will taint the rest of the block, giving him the status of an "underwriter" who may not sell any additional shares without a current prospectus.[25]

The Commission's position seems to be as follows: if a block of shares subject to investment restrictions is registered, but only part of the block is actually sold under the registration statement, the SEC will sometimes decline to give a no-action position permitting free sale of the balance. However, the SEC will adopt a no-action position if there has been a relatively long lapse of time, equivalent to a new investment holding period, between the last registered sale and the first free sale. Thus, we have an anomalous result, which seems to conflict with the statutory purpose in that registration of investment shares may be discouraged. An investment holder may seriously prejudice his position by selling part but not all of his investment

[24] The holders would be underwriters since the subject shares were taken "with a view to . . . distribution." Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1964). Once a person becomes an underwriter with respect to particular securities, it is very difficult to shed that status, no matter how long the securities are held. *See* SEC Securities Act Release No. 4890, ¶ 10 (Dec. 20, 1967) (dealing with underwriters' options); SEC Securities Act Release No. 4749 (Dec. 23, 1964) (adopting rule 174).

[25] Registration rights often arise by contract through "piggy-back" commitments: the issuer of investment securities will agree to include them in a registration statement being filed by the issuer for another purpose. The dilemma is especially acute for the investment holder relying on piggy-back rights, since he does not normally have any assurance when the next registration opportunity will arise. It has been reported that the mere fact of registration, (even if no shares are sold under the registration statement) may under certain circumstances be a factor considered by certain SEC staff members as negating an investment intent. However, no such adverse inferences are drawn from the fact that an investment purchaser bargains for registration rights if the rights are not exercised.

stock during the investment holding period, even under a registration statement. He is encouraged to wait out the holding period and avoid any registered sales.

This very question—the ability to sell shares at a deferred date without a current prospectus—was involved in the acquisition of F Co. by G Co. The agreement clearly established the F family's intent to make a current sale of one third of its stock. After the papers were signed, G Co.'s accountants advised that they could not treat the transaction as a pooling of interests (the accounting treatment which G Co. desired to follow) if the family had a present intention to sell more than twenty-five per cent of its stock.[26]

The family was most accommodating, and offered to limit their current sales to twenty-five per cent if G Co. would give the family whatever additional registration rights were necessary to accomplish a deferred sale of the 8.33 per cent increment—the difference between one third and one fourth of the shares received. G Co. would not agree, however. In its view the commitment requested was too burdensome since it could run, potentially, forever. The final solution was to account for the transaction as a purchase rather than a pooling, even though purchase treatment was thought by G Co.'s management to be a less desirable presentation for the particular transaction.

Having wrestled with these problems, let us consider what actually occurred. It was determined that the full 300,000 G Co. shares should be registered for sale from time to time by the F family. After the registration statement became effective, a major New York City bank purchased the family's block of G Co. stock at a negotiated discount slightly below the then market price. The bank was fully familiar with G Co., since it already held substantial blocks of G Co. stock in several investment accounts.

At first there was concern among the attorneys whether the distribution would be completed with the sale to the bank, or whether the bank would need a prospectus on its resale. This is a variation of the recurring question whether shares may be registered for a negotiated sale to one or a limited group of persons in order to give the purchaser stock which may thereafter be resold without registration.

To the delight of all concerned, it was discovered that the bank intended to place the stock in several different fiduciary accounts. The

[26] For a discussion of the differences between the "purchase" and the "pooling" accounting treatments, see L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE, 19.10-19.26 (2d ed. rev. printing 1966); Gormley, *The Pooling of Interests Principle of Accounting—A Lawyer's View*, 23 BUS. LAW. 407 (1968).

bank officer in charge of the matter was given a copy of the prospectus for each account.[27] It was concluded that the shares had come to rest in the hands of the investing public [28] and that the public distribution had been completed in full compliance with the law. Of course, as the statute permits, the prospectuses were delivered long after the bank officer's oral commitment to buy the stock, although before the delivery of any certificates or written confirmation.

Here are some final facts by way of epilogue:

The family was delayed more than a year after the acquisition before any shares could be sold. In the interval, the market value of the shares dropped by about $1,000,000, consistent with the decline in the market as a whole during the period.

Although the stock's price was in a slump at the time, the bank which was executor of Older Brother's estate insisted on selling all of his shares. The bank felt this was the only prudent course to follow. It was concerned with the uncertainty regarding the salability of any shares remaining unsold after the original prospectus information became stale. Although the family had the right to demand updating of the registration statement, it was recognized that further delay and expense could be involved.

The legal fees to all parties relating directly to SEC problems, apart from consummation of the deal itself, were estimated to exceed $100,000. It is doubtful that anyone ever read the prospectus other than the parties preparing it, the SEC staff (which developed an extensive comment letter), and the printers, who charged $15,000 for their efforts.

II. Some Other Anomalies

The foregoing example illustrates some of the many problems relating to acquisitions for stock under the federal securities acts. There are others, as the following brief survey will indicate. For ease of analysis,

D refers to the disappearing (acquired) company;

S refers to the surviving (acquiring) company.

Unless otherwise indicated, I will be dealing only with cases in which S, the corporation making an acquisition through issuance of its own securities, is a "registered company," meaning, for purposes of this

[27] Copies of the prospectus were also lodged with the New York Stock Exchange, pursuant to SEC rule 153, 17 C.F.R. § 230.153 (1968). It is well known that prospectus copies delivered under this rule are rarely read by anyone. Since the sale to the bank was handled as a "cross" on the Exchange, it might have been unnecessary under rule 153 to deliver copies to the bank, but delivery was made out of an excess of caution.

[28] See note 90 *infra*. Some SEC officials might consider these shares as sold to a single buyer, characterizing it as an "underwriter."

article, one with a class of equity security registered under section 12(b) [29] or 12(g) [30] of the Securities Exchange Act of 1934. Registered companies are subject to the proxy,[31] periodic reporting,[32] and insider trading [33] provisions of the 1934 Act.

First to be considered is the way in which the form of the transaction can affect the extent of the required disclosure.[34] If the transaction takes the form of a merger, no registration statement or other disclosure relating to the merger is required under the 1933 Act registration provisions. However, regardless of the significance of the merger to S, a comprehensive composite disclosure document on both companies—the merger proxy statement [35]—is generally [36] required under the 1934 Act.

If the acquisition takes the stock-for-assets form, again no disclosure in connection with the acquisition is required under the 1933

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[29] Securities Exchange Act of 1934 § 12(b), 15 U.S.C. § 78*l*(b) (1964) (relating to exchange listed securities).

[30] *Id.* § 12(g), 15 U.S.C. § 78*l*(g) (relating to over-the-counter securities).

[31] *Id.* § 14, 15 U.S.C. § 78n.

[32] *Id.* § 13(a), 15 U.S.C. § 78m(a).

[33] *Id.* § 16, 15 U.S.C. § 78p.

[34] Of course, some elements of the present pattern are partially dependent upon state law provisions, which generally require shareholder votes for mergers or increases in authorized shares, or upon stock exchange requirements which require votes for major acquisitions irrespective of form, even if no vote is required by state law.

Irrespective of the filing requirements arising directly under the federal securities acts, stock exchanges generally require the filing of listing applications in connection with any issuances of stock of the listed class. The applications must give certain information on the transaction giving rise to the issuance. Furthermore, the New York and American Stock Exchanges require approval of S's stockholders, solicited under the SEC's proxy rules, for major stock acquisitions, even if no stockholder vote is otherwise required by state law. *See* note 63 *infra.*

[35] As used herein, "merger" refers to the conventional statutory merger where D merges directly into S pursuant to a shareholder vote of both parties.

An increasingly popular technique which avoids the need for S's stockholders to vote, is the merging of D with a subsidiary of S which has been capitalized with stock of its parent, S. Irrespective of which corporation survives the merger, the agreement may provide (at least in certain states—*see* DEL. CODE ANN. tit. 8, § 251(b)(4) (1968)) that the D stockholders will receive S stock in exchange for their D stock. No doubt the burden and delay of preparing the proxy statement is one of the reasons that large companies avoid the conventional merger as the form for relatively small acquisitions.

No matter how immaterial the merger is to S and how closely held is D, if state law requires a vote the SEC has no power to waive the requirement that S use a proxy or information statement under the present proxy rules (although it has broad power to amend the present rules). *See* SEC rule 14a-3, 17 C.F.R. § 240.14a-3 (1968); SEC rule 14c-2, 17 C.F.R. § 240.14c-2 (1968). *See also* SEC Schedule 14A, Item 14, 17 C.F.R. § 240.14a-101 (1968), as to disclosures required for an acquisition. On the other hand, the Commission does have some degree of administrative discretion, in commenting on proxy material, to consider such factors as the materiality of the merger to the proxy-soliciting company. It also has reserved to itself the express right to modify the financial statement requirements. *See* SEC Schedule 14A, Item 15(c), 17 C.F.R. § 240.14a-101 (1968).

[36] Under a recent amendment to Delaware law, no S stockholder vote, and therefore no S proxy statement, would be required for a merger which would increase S's outstanding stock by 15% or less of the amount outstanding immediately prior to the merger. DEL. CODE ANN. tit. 8, § 251(f) (1968).

Act. A stock-for-assets acquisition, irrespective of its significance to S, will require a proxy statement from S if S does not have sufficient authorized but unissued shares already available to complete the acquisition.[37] Stock exchange rules may also require S to solicit proxies with a proxy statement for a major stock-for-assets acquisition.

A Form 8-K report[38] may be required of S under the 1934 Act if the stock-for-assets transaction is of sufficient significance to S. However, the present Form 8-K report gets limited dissemination and is generally a disclosure document of markedly inferior quality and content compared to a prospectus or merger proxy statement. For example, a Form 8-K report on an acquisition, no matter how significant the transaction, does not contain the pro forma financial data (showing retroactively what the financial statements would have been if the companies had been combined earlier) or the comparative data of a merger proxy statement. A stock-for-assets acquisition may also require a proxy statement or Form 8-K report from D, if it is subject to the applicable 1934 Act provisions.[39]

If the acquisition takes a stock-for-stock form,[40] there is no disclosure required under the 1933 Act if the "private offering" exemption of section 4(2) applies.[41] If D is publicly owned, thus making the private offering exemption inapplicable, an excellent composite disclosure document on both companies, the exchange offer prospectus, must be used. As a practical matter, and despite occasional intimations to the contrary,[42] the factor which normally determines whether the

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[37] If S submits to its shareholders a proposal to increase the authorized shares, the proxy statement must describe the transaction in which the shares are to be issued. *See* SEC regulation 14A, 17 C.F.R. § 240.14a-1 to 14a-12 (1968); SEC Schedule 14A, Item 13, 17 C.F.R. § 240.14a-101 (1968). As the SEC interprets this requirement, if S has a specific acquisition in mind, the acquisition must be described as though the shareholders were being asked to vote on the acquisition itself. If there is no specific acquisition pending at the time of the proxy solicitation, S may state simply that the shares are intended to be used in connection with future acquisitions. This interpretation of the proxy rule has encouraged many companies to seek stockholder approval, at a time when no acquisitions are pending, for large increases in the authorized but unissued stock for the purpose of future acquisitions.

[38] SEC Form 8-K, Items 2, 7, 17 C.F.R. § 249.308 (1968).

[39] In addition to registered companies, there are some companies which are subject to periodic reporting under Securities Exchange Act of 1934 § 15(d), 15 U.S.C. § 78o(d) (1964), but which are not subject to the proxy or insider trading provisions.

[40] It would appear that a stockholder vote is sometimes required for a stock-for-stock acquisition. *E.g.*, OKLA. STAT. ANN. tit. 18, § 1.170a (Supp. 1967). If rule 133 applies to a stock-for-stock acquisition requiring such a vote, the transaction probably would have most of the attributes of a stock-for-assets transaction for securities acts purposes.

[41] 15 U.S.C. § 77d(2) (1964).

[42] There are at least two factors discussed in the authorities as indicative of a private offering: (1) the purchasers must have access to the kind of information which a registration statement would disclose; and (2) the purchasers must be able to fend for themselves. *See, e.g.*, SEC v. Ralston Purina Co., 346 U.S. 119 (1953); United States v. Custer Channel Wing Corp., 376 F. 2d 675 (4th Cir. 1967), *cert. denied*, 389 U.S. 350 (1967); D. F. Bernheimer & Co., 41 S. E. C. 358, 363 (1963) (holding the private

exchange offer prospectus is required, or whether no disclosure under the 1933 Act is required, is the number of stockholders of D. The need for a prospectus is generally unrelated to the materiality of the acquisition from S's point of view. A stock-for-stock acquisition will require a Form 8-K filing if it is significant to S, or if D is a 1934 Act reporting company.[43] As in the case of a stock-for-assets transaction, the stock-for-stock acquisition may require a proxy statement from S if it requires the authorization of additional stock, or if it is a major acquisition involving a listed stock.

Next to be examined is the extent to which, under current law, the D stockholders may resell, without further restriction, the S securities issued to them in the acquisition. In practice, problems of this type are among the most troublesome to both the lawyer and the businessman.[44] The law at present is in an unsatisfactory state. The restrictions on resale relate largely to the form of the transaction, without regard to the many other factors more relevant to the need of the trading market for disclosure. A great deal of time and effort is expended in preparing registration statements which no one reads and which are of very little utility from the point of view of the overall statutory purpose.[45]

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offering exemption inapplicable to an offering to 22 persons, most of whom were already security holders of the issuer, since neither factor was shown to exist).

> On occasion the Commission stresses the first factor as a *sine qua non,* reasoning: The exemption does not become available simply because offerees are voluntarily *furnished* information about the issuer. Such a construction would give each issuer the choice of registering or making its own voluntary disclosures without regard to the standards and sanctions of the Act.

SEC Securities Act Release No. 4552 (Nov. 6, 1962).

If this line of reasoning were to be followed (although it has not been followed consistently in the past), the private offering exemption would only apply if all of the offerees were top executives of the company or otherwise had direct and *independent* access to the type of information which a prospectus would disclose. (Query if the access test is met when S has filed material with the SEC).

Nothwithstanding these occasional pronouncements, most experienced practitioners would normally consider the private offering exemption to be applicable to any stock-for-stock acquisition, regardless of the lack of *independent prior knowledge* of S by the D stockholders, if the number of D stockholders were relatively small (possibly up to 25), and if they made appropriate investment representations. See the statement of a senior Commission official in WHEN CORPORATIONS GO PUBLIC 16 (C. Israels & G. Duff, Jr. eds. 1962): "The Commission has, as a rule of thumb, generally agreed not to raise the question of registration for an offering say to twenty or twenty-five people, particularly if they can show some close relationship to the venture."

[43] D would file a Form 8-K report dealing with a change of control pursuant to Item 1.

[44] The analysis which follows in the text assumes that S does not issue a convertible security. Entirely new complexities arise in any essentially private acquisition transaction which involves the issuance of a convertible security. *See* SEC Rule 155, 17 C.F.R. § 230.155 (1968).

[45] For example, in June, 1968, a registration statement of Minnesota Mining and Manufacturing Company, SEC file 2-28852, became effective. It covered 29,275 shares of common stock, representing about 1/20 of 1% of the 54,000,000 shares outstanding. The stock was owned by ten selling stockholders who received their shares in a stock-for-assets acquisition so insignificant to 3M that the registration statement

If the transaction is an unregistered stock-for-stock exchange, normally the "private offering" exemption is relied upon and all of the stock is treated as "investment" stock. Generally speaking, this means that, initially, none of the newly issued S shares may be sold publicly by any D stockholder in any manner without registration. However, any of the shares may be sold by any D stockholder in any manner after an unanticipated change of circumstances.[46] The unanticipated change may be in the circumstances of the company (a factor suggesting that current disclosure certainly should be made), or of the individual investor (a factor totally unrelated to the needs of the trading markets). As a practical matter, the shares may also be sold in any manner after the lapse of a sufficient amount of time, the period being rather indefinite but probably two to three years. For the record, however, it is official dogma that if stock is acquired for investment, a lapse of time (no matter how long) does not automatically free the stock from restrictions on resale.[47] Other factors, such as an unsuccessful attempt to sell during the holding period, may negate the original investment intent, in which event the holder is treated as an underwriter *ab initio*.

If the acquisition is a merger or stock-for-assets transaction to which rule 133 applies, then, irrespective of the significance of the acquisition or the extent of disclosure which accompanied it, any of the shares may be sold in any manner by any non-controlling shareholder of

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did not indicate anything whatsoever about the acquired company other than the fact of the acquisition. The registration statement indicated that the shares either may be offered from time to time at prices then prevailing on a security exchange on which the shares are traded, or may be pledged. The transaction was treated as a pooling of interests, so it may be surmised that the selling shareholders had no present intention to distribute a major portion of their shares in the near future, a fact confirmed by the statement in the prospectus that no period of time had been fixed within which the shares would be offered, sold or pledged. The estimated expenses to 3M of the offering were $10,000, which included nothing for legal expenses, apparently because the documents were prepared by house counsel. The leakage provisions of rule 133(d) and (e) would have permitted the free sale of the 3M stock in the open market by the selling stockholders but for the close relationship among them which made the negotiated transaction exception applicable. *But cf.* notes 5-6 *supra* and accompanying text.

[46] *See* SEC Securities Act Release No. 4552 (Nov. 6, 1962).

[47] Whether or not a person acquires securities with a view to distribution may be inferred—it is said—from what he does. An immediate resale will thus negate the original investment representation, absent a change of circumstances. However, according to the dogma, the fact of sale after a sufficient holding period will not negate the initial investment representation if there are no other circumstances during the intervening holding period to negate the original representations.

An early General Counsel's opinion indicated that a holding of one year was a sufficient time lapse so that no adverse inference normally would be drawn from a subsequent sale. SEC Securities Act Release No. 1862 (Dec. 14, 1938). A more recent statement by the present Commission Chairman set the period at two years. S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 30-31 (C. Israels ed. 1962). *Cf.* United States v. Sherwood, 175 F. Supp. 480 (S.D.N.Y. 1959).

D.[48] Controlling shareholders are permitted to sell in routine brokerage transactions to the extent permitted (whatever that may be) by rule 133(d) and (e). Except to the extent that the rule 133 leakage provisions apply, the controlling persons of D are probably treated much like investment purchasers of S stock in an unregistered stock-for-stock exchange.[49]

If the shares issued in the acquisition are registered, there may be some uncertainty concerning the consequences. If the registration statement covers shares *already issued* in an exempt private transaction (or to controlling persons of D in a completed rule 133 transaction), the holder may be tagged as an underwriter. In such an event he will need a current prospectus for any sales, no matter how long deferred, even for routine brokerage transactions from time to time involving an insignificant number of shares. If the registration statement is filed *before* the shares are issued, the shares may be completely free of further restriction, although this is far from clear.[50]

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[48] *But see,* with respect to investment holders of D stock, note 16 *supra* and accompanying text. See note *72 infra* regarding controlled persons.

[49] Some lawyers believe that after two years a controlling person of D is completely free from any further restrictions on resale, unless he has become a controlling person of S. They draw support for this conclusion in part from Undertaking 6 of SEC Form S-14, 17 C.F.R. § 239.23 (1968). Form S-14 is a 1933 Act registration form designed for use of D controlling stockholders in selling shares received by them in certain rule 133 transactions. It is normally prepared by physically incorporating S's proxy statement. The required undertaking is that S will keep the registration statement updated for 24 months after its effective date. The normal investment purchaser has no such straw to grasp as a guideline regarding lapse of time. *See generally* Throop, *Recent Developments with Respect to Rule 133,* 15 BUS. LAW. 119, 129-31 (1959). *But see* 1 Loss 537-38.

On the other hand, it may not be as clear in a rule 133 transaction as it is in a private offering that the former controlling persons of D may rely on the change of circumstances doctrine to permit free sales of shares recently acquired.

[50] If the registration statement is treated as a conventional exchange offering, there seems to be no clearly stated restriction on the redistribution of the newly issued shares. Query the extent to which the limitations on free resale can be avoided if the parties arrange the transaction in advance of the registration statement becoming effective.

Some major companies have "shelf" registration statements for shares to be issued in future acquisitions not yet negotiated. In theory, the D stockholders in such cases could be treated as offerees in a non-exempt public offering who get free stock—that is, stock already registered for issuance to them which can be resold freely. However, in discussions with the SEC staff, a flavor emerges: if the private offering exemption *could* apply (assuming that the D stockholders had made investment representations), then the D stockholders (or possibly only the controlling stockholders of D) will be treated as "underwriters," even if the issuance to them is registered in the first instance. *Cf.* SEC Securities Act Release No. 4248, Part VI (July 14, 1960) (dealing with rule 155). The consequence is that any D stockholder tagged as an "underwriter" (so long as he is so tagged) cannot resell his shares without delivery of a current prospectus at the time of his sale.

The staff now discourages such shelf registrations. However, they should be encouraged for acquisitive companies as a means of producing an excellent disclosure document which is updated at least once a year. Presumably it is also updated on an interim basis whenever there is an acquisition which requires an updating, under the rather vague standards dealing with updating of prospectuses to reflect post-effective material events.

For an analysis of the advantages and disadvantages of such shelf registrations, see S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 182-229

In this connection, consider the practical consequences of the prospectus delivery requirements on resales requiring registration by D stockholders. Sometimes the broker-dealer through whom the shares are sold solicits the purchase orders from his own customers or other purchasers such as institutions. In such cases, there is some element of communication between the seller and buyer (possibly with various brokers as intermediaries), and it may be practicable to deliver a prospectus to an identifiable purchaser.

In many cases, however, the shares are simply fed into the trading market for sales from time to time in routine brokerage transactions. There is no channel of communication between the seller and the ultimate purchaser. In this situation it is virtually impossible to make an effective prospectus delivery to the ultimate purchaser (even granting the somewhat doubtful premise that one can identify the purchaser of any particular shares among a fungible mass).[51] In actual practice, the statutory prospectus delivery requirement is very largely ignored, except for sales on an exchange where a fictional delivery to the exchange itself satisfies a statutory mandate if not a practical purpose.[52]

III. An Approach to a Solution

There is reason to believe that many of the difficulties and anomalies discussed above will soon be eliminated, or at least substantially ameliorated. The Commission recently appointed an internal study group, under the chairmanship of Commmissioner Francis M. Wheat, to review the disclosure pattern under the 1933 and 1934 Acts.[53] It is to be hoped that this study group will develop a disclosure system restructured with respect to acquisitions, to achieve closer correlation between the disclosure requirements and the objectives to be served by such requirements.

(C. Israels ed. 1962). Part of the objection to this type of shelf registration stems from the problems of compliance with the 1933 Act in connection with the resale of the shares by the D stockholders. However, these problems will become less significant if the need for registration of their resales is deemphasized, as suggested below in this article. Even if we eliminate the need for 1933 Act registration for resales by D stockholders, [1934 Act] SEC Rule 10b-6, 17 C.F.R. § 240.10b-6 (1968), will still be applicable to control market manipulation. *See* SEC Securities Act Release No. 4371, at 20 (June 7, 1961) (Hazel Bishop, Inc.), SEC Securities Act Release No. 4401 (Aug. 3, 1961).

[51] The ability to trace particular securities will probably become increasingly difficult as computers substitute bookkeeping entries for the physical delivery of certificates as part of the trading process. As a step in this direction, the New York Stock Exchange instituted its Central Certificate Service in late June, 1968. Indeed, the complete elimination of stock certificates as evidence of share ownership has been suggested. Jolls, *Can We Do Without Stock Certificates? A Look at the Future,* 23 Bus. Law. 909 (1968).

[52] *See* SEC Rule 153, 17 C.F.R. § 230.153 (1968) (regarding sales on a stock exchange).

[53] SEC Securities Act Release No. 4885 (Nov. 29, 1967).

The reforms suggested herein can be accomplished substantially, if not completely, through administrative action by the Commission, principally through the promulgation of revised rules and forms, and without statutory amendment. As I have indicated elsewhere, the Commission has vast administrative authority to revise the existing requirements and to make them more rational.[54] There is also a movement underway to restructure the securities laws through the enactment of an overall federal securities code.[55] No doubt the codification program will also address itself to the peculiar problems posed by acquisitions.

In terms of the number of transactions and the value of securities issued, acquisitions now rival, if they do not surpass, conventional offerings as a format for the issuance of stock.[56] For this reason alone, acquisition transactions should be one major focus of any reform program.

To a large degree, the theology designed for conventional public offerings has been applied to acquisitions, although it is not fully suited to the latter context. Several factors distinguish acquisitions as a unique type of transaction, different from other issuances of securities.

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[54] Schneider, *Reform of the Federal Securities Laws*, 115 U. PA. L. REV. 1023, 1028-32 (1967) [hereinafter cited as *Reform*]; Schneider, *An Administrative Program for Reforming the Federal Securities Laws*, 23 BUS. LAW. 737 (1968). For a rather broad statement by the Commission concerning its power to restructure the law in order to implement the statutory purpose, see SEC Securities Act Release No. 3965, Conclusions II and III (Sept. 15, 1958) (relating to rule 133).

The Commission recently authorized the use of an abbreviated form in a very interesting manner. 1933 Act Form S-7 applies to the cash sale of certain high-grade securities. The Commission recently announced that it "has approved the usage" of this form for the registration of stock of domestic companies issuable upon conversion of certain Eurobonds. The Commission has indicated that it will waive the cash offering requirement with respect to such form. The action was taken pursuant to Rule 401, 17 C.F.R. § 231.401 (1968), which provides that a registration statement is filed on the proper form unless the Commission objects to the use of the form prior to the effective date. In effect, the Commission has almost accomplished an informal amendment of the Form's requirements—but not quite. The announcement goes on to state: "However, the use of Form S-7 will not be allowed for securities issuable upon conversion of Eurobonds *where such use would not be appropriate.*" CCH FED. SEC. L. REP., Weekly Report No. 201, at 3 (May 22, 1968) (emphasis added).

[55] Loss, *History of SEC Legislative Programs and Suggestions for a Code*, 22 BUS. LAW. 795 (1967).

[56] During the calendar year 1967, there were at least 1,500 acquisitions involving the issuance of S stock. The total consideration involved in these acquisitions (a part of which was represented by cash or debt securities) was $15 billion. This total includes only acquisitions involving a consideration of more than $700,000. *Mergers on Parade*, 3 MERGERS & ACQUISITIONS, Jan., 1968, at 86-87. During the year ending June 30, 1967, 1,649 1933 Act registration statements became effective, not all of which involved conventional underwritings of stock. For that year, registered sales of stock (as opposed to debt securities) offered for immediate cash sale to the public (as opposed to various types of non-cash offerings or offerings over an extended period of time) amounted to only about $1.2 billion out of about $34 billion of securities offered under registration statements becoming effective. SECURITIES AND EXCHANGE COMMISSION, 33RD ANNUAL REPORT 25-28, 154-56 (1967). The pace of acquisitions for stock has accelerated in 1968. Wall Street Journal, July 9, 1968, at 13, cols. 2-3.

When S acquires a business for stock in an acquisition, the situation is not the same as when S sells stock to the public through a professional, and thereafter buys assets with the cash proceeds. In conventional public financing, the stock is offered to investors at large through professionals who are paid for their efforts, creating the situation requiring 1933 Act protections. On the other hand, in an acquisition, S stock is offered to a specific group, the D shareholders, and the assets to be acquired by S are the particular ones owned by D. The process by which the S shares are distributed in an acquisition is a complex transaction of which the issuance of securities is only one incident.

The D shareholders are offered a unique transaction in terms of what they give up and what they receive in exchange. Each D shareholder must make an individual investment decision. However, the D shareholders as a group act collectively in the sense that normally they are participating in a transaction negotiated on their behalf by the D management, which the D shareholders have designated as the stewards of their investment and who thereby assume fiduciary obligations. The D management, advised by its attorneys, accountants and others, usually has the sophistication and economic power to bargain for appropriate contractual disclosures and protections, entirely apart from those conferred under the securities acts. In a sense, the D shareholders may be considered as a group able to fend for themselves, a group not entirely dependent on the 1933 Act protections. Furthermore, D shareholders often receive a premium for their company in terms of the comparative market values of S and D, especially if D is a relatively small company compared to S. To the extent that D shareholders are bargain purchasers of S stock, the need for 1933 Act protections may be somewhat lessened.[57]

Upon receipt of S stock in an acquisition, D shareholders normally act like "investors" rather than "underwriters," using those terms in a non-technical sense. Even if a D shareholder intends to sell some or all of his S stock following the acquisition, it is quite likely that his sales pattern will be that of the typical public investor engaged in

[57] The registration provisions of the 1933 Act apply to offerings to employees the same as any other public investors. SEC v. Ralston Purina Co., 346 U.S. 119 (1953). Although the SEC has stressed this point (SEC Securities Act Release No. 4552 (Nov. 6, 1962)), it has adopted a registration form with abbreviated disclosures for public offerings to employees under various types of employee benefit plans. SEC Form S-8, 17 C.F.R. § 239.166 (1968). In adopting Form S-8, it noted that many plans covered by the form provide the employee with a bargain purchase opportunity, and that it was responding to the suggestion "that the investment decision to be made by the employee is of a substantially different character than is involved where securities offered for the purposes of raising capital are sold upon the best obtainable terms." SEC Securities Act Release No. 3480 (June 16, 1953); *cf.* SEC Securities Act Release No. 3469-X (April 12, 1953).

routine open market trading transactions. The D shareholders are not like the professionals—the more usual recipients of securities in non-open-market transactions—who are engaged regularly in the business of trading or distributing securities. If we assume that D shareholders were bona fide investors in D for some time prior to the acquisition, who must assume all the investment risk with respect to S stock as soon as acquisition is complete, it is not likely that arm's-length acquisitions will be used as the form for a transaction which is primarily motivated by a desire to distribute securities to the public at large.

The remainder of this article will analyze various unique problems posed by bona fide acquisition transactions [58] and will suggest certain goals, objectives and priorities for a revised disclosure system. It will offer a preliminary outline of one approach to a revised system.

A guiding principle should be that the disclosure (if any) required in connection with an acquisition should relate to the needs of the investing public, including the existing stockholders of S and D, in the particular circumstances involved. The resale of the newly issued securities should be restricted, if at all, only for sales constituting "distributions," as opposed to routine trading transactions. Both of these principles should apply equally to all acquisitions, irrespective of the form of the transaction. That is, the disclosures and resale provisions applicable to any given acquisition should be determined without regard to whether the transaction takes the merger, stock-for-stock or stock-for-assets form. The approach suggested here is, frankly, inconsistent with the "no-sale" analysis underlying the present rule 133. The present rule is unforgivably formalistic [59] and

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[58] The stock-for-assets acquisitions discussed herein are of the conventional sort where D liquidates and distributes the S stock to the D stockholders, although it is possible for D to continue as a holding company retaining intact the entire block of S stock.

There are also certain special types of acquisitions which present unique problems beyond the scope of this article. (1) The acquisition where S and D are under common control. (2) The "reverse acquisition" where the company which disappears as a matter of form is actually the dominant company and its management controls the survivor after the merger. (3) The situation where control of D changes immediately prior to the acquisition. In such a case, the control persons of D may not be bona fide investors in D, but rather persons merely using D as a vehicle to obtain S stock.

The triumph of form over substance in the present law is especially evident in these special cases. For example, if X merges into a larger company, Y (the conventional arrangement), the former controlling person of X is permitted to sell his shares without registration only as permitted by rule 133's leakage provision. However, if there is a "reverse merger" of the dominant Y into the smaller X, the former controlling person of X becomes simply another non-controlling stockholder of the enterprise, and (arguably) he may sell all of his shares without registration and without any of the limitations of rule 133.

[59] *See* note 95, *infra*. That some find the formalisms charming is no reason to forgive their ill effects.

attaches crucial significance to the form rather than the substance of the transaction.

The revised system should afford a reasonable degree of predictability. Possibly, we could achieve the optimum level of disclosure by dealing with each case on an ad hoc basis, taking into account such factors as the relative size of each company, the degree of its public ownership and the information theretofore available. However, such an ad hoc approach would result in an unacceptable lack of certainty. Inevitably, we will have to establish broad classifications which must be somewhat arbitrary in order to be sufficiently definite. We must recognize that in extreme cases there may be instances of over- or under-disclosure. In the interest of clarity, the analysis below makes certain assumptions about various types of transactions, with full realization that these assumptions will not be completely valid in every case.

The following sections will focus on three separate but related questions relative to acquisitions: the degree of required disclosure in filings with the SEC relating to the acquisition itself; the nature of the filing under the statutory scheme; and the extent to which 1933 Act registration should be required for the sale of the newly issued stock by the D stockholders.

A. The Extent of Disclosure Required

As suggested above, the extent of the disclosure required to be filed by S in any acquisition should not vary significantly with the form of the transaction,[60] but rather should relate to circumstances more relevant to the needs of public investors. Preliminarily, the many possible combinations of circumstances should be recognized. For example, the acquisition may be very significant to S, or it may be relatively unimportant; D may or may not be a registered company (there are other subcategories, such as publicly or privately held non-registered companies). The extent of disclosure for each company must be decided in light of the particular circumstances involved.

It is important to separate various objectives which the disclosure system might serve. These include the following: to inform the investors of S about what is happening to their company; to inform the investing public generally about what is happening to both companies; to inform the trading market about any resale of the newly issued securities of S after the acquisition; and to inform the stockholders of

[60] Of course, there are certain respects in which the form of the acquisition must be reflected in the filing. For example, if it is a merger being submitted to a stockholder vote, the proxy statement should give information on voting procedures, appraisal rights, etc.

D about what they are giving up and what they will receive in exchange. It should be noted that every acquisition will be significant from D's point of view, since it will result in a change in the enterprise in which its stockholders have an investment (or, possibly, in a liquidation of their investment).

In revising the system, requirements could be contrived that would assure full disclosure to everyone about everything involved in every acquisition, until all of the newly issued securities have been completely distributed. However, the burdens of such a system would be intolerable. It must be recognized that there are practical limits to the burdens that can be imposed. The most important objective of the disclosure system should receive priority in each circumstance.

We now turn to the specific types of transactions and the scope of the SEC filing which should be required from S, reserving for the moment the question of how the filing should fit within the statutory framework. Recognizing that it is desirable to make some (but not too many) easily identified classifications, the following divisions seem appropriate for purposes of further discussion. Acquisitions are classified from S's point of view as being highly significant, moderately significant, or insignificant. Another relevant variable is whether D is or is not a registered company.[61]

If the acquisition is highly significant to S, a full-dress presentation should be required: a composite disclosure document covering both companies, including comparative and pro forma financial statements, equivalent to the present merger proxy statement or exchange offer prospectus.[62] "Significance" might be determined in accordance with several standards of comparison between S and D, including relative total assets, gross revenues, net income, shareholders' equity, the proportion of the common stock being issued by S (adjusting for conversions of convertible securities), or the value of the stock and other consideration paid by S in relation to its total assets. These tests should be applicable in a relatively mechanical manner. If D contributes a specified minimum to the combined S-D enterprise by any of the standards of comparison, the transaction should be considered highly sig-

[61] I do not rule out the desirability of further classification of non-registered companies (*e.g.*, publicly and closely held companies), although I see the merits in keeping the number of categories to a minimum in order to have a workable system from the administrative point of view.

[62] The Commission should retain the discretion which it now has to reduce the burdens in appropriate circumstances. *See, e.g.*, note 35 *supra*. The extent of disclosure required about S might well parallel the requirements which would apply to a conventional public offering by S. These latter requirements vary with the size and stability of S and the amount of information previously available, among other factors. *See, e.g.*, SEC Form S-1, 17 C.F.R. § 239.11 (1968); SEC Form S-7, 17 C.F.R. § 239.26 (1968); SEC Form S-9, 17 C.F.R. § 239.22 (1968).

nificant to S. For example, the transaction might be considered highly significant if D contributes more than twenty-five per cent to the combined enterprise, meaning that it was at least one third as large as S prior to the acquisition, by the standard of comparison being used.[63]

Next to be considered is the acquisition which is moderately significant to S—for example, if D contributes more than ten per cent to the combined enterprise by one or more standards of comparison, but less than the minimum for a highly significant transaction. It is proposed that if D is a registered company, the full-dress treatment should be used, since it should be developed in any event for the relatively large group of D stockholders. If D is not a registered company, the following compromise is suggested. S should make a disclosure filing which does two things. First, it should report the acquisition itself, giving some brief information about D, and also the number of shares being issued. (The filing might approach in content the present Form 8-K report which typically does not go into the detail of a full Form S-1 registration statement in describing the business of D.) Second, the filing should state that the basic business, property and management information filed with the SEC by S within the recent past, say two years, complied with the applicable requirements *at the time of filing;*[64] but S should have the alternative of restating such information currently in a new filing if it is not satisfied with its original filings as of their filing dates. This second requirement does not impose the burden on S to update all of its information as of the filing relating to the

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[63] Compare the standards in SEC Form 8-K, Item 2, Instruction 4, 17 C.F.R. § 249.308. An acquisition is considered significant for that purpose if: (1) the book value of D exceeds 15% of the total assets of S; (2) the amount paid for D exceeds 15% of the total assets of S; or (3) D's gross revenues exceeded 15% of S's gross revenues for the past year. There is a long outstanding proposal by the SEC to drop the percentages to 10%. SEC Securities Exchange Act Release No. 4795 (Dec. 31, 1964).

Item 7 of Form 8-K requires a "brief description" of any transaction which increases by more than 5% the amount outstanding of any class of security.

The major stock exchanges require a shareholder vote under the SEC proxy rules, whether or not a vote is otherwise required by state law, on any acquisition which would increase the outstanding common stock by 20%, or if the common stock and other consideration issued by S in the acquisition have a combined fair market value approximating 20% or more of the market value of S's outstanding common stock. NEW YORK STOCK EXCHANGE, COMPANY MANUAL, at A-284; CCH AMERICAN STOCK EXCHANGE GUIDE, ¶ 10,046 (1966).

See also the 15% test in Delaware, discussed in note 36 *supra,* relating to voting requirements.

[64] Basically, it is intended that the current filing should, in effect, incorporate by reference the previously filed material of continuing interest and reaffirm its accuracy as of the original filing date. However, prior filings may contain some information of only minor or transitory interest (such as the details on a stockholder vote, see SEC Form 8-K, Item 11, 17 C.F.R. § 249.308 (1968)), which can be excluded from the coverage of the current reaffirmation. Furthermore, if one prior filing contains information superseding an earlier filing on the same subject, only the later filing should be reaffirmed.

acquisition, but merely affirms currently that S has contributed to the reservoir of public information in the past, in accordance with the then applicable requirements.

It is important to note that if the SEC study group adopts another recommendation often made, the periodic reporting requirements under the 1934 Act will be upgraded, so that the current filings at any time will approach in content an updated prospectus. Financial and management information is now adequately updated by registered companies on an annual basis, through the Form 10-K report and the proxy statement respectively. The principal deficiency in the content of 1934 Act filings at the present time is their failure to update business and property information.[65]

The final category of transactions is the acquisition which is insignificant to S. At the outset it should be noted that most transactions in this category are now receiving full-dress treatment—through either a merger proxy statement or an exchange offer prospectus—*if* D is a registered company. If D is not registered, most current acquisitions in this category are being cast in a form which requires no substantive disclosure filing, that is, a filing giving business, management and financial information about the two companies. Generally speaking, it is suggested that this pattern be preserved, although we should reach the result directly and relieve the pressure to have securities acts considerations dictate the form of the transaction.

If D is a registered company, a relatively complete disclosure document should be used. It should approach the full-dress treatment of the current merger proxy statement, except that the pro forma financial presentation may be deemphasized since, by hypothesis, the transaction will have relatively little impact on S. As a registered company, D is a comparatively significant one, with reasonably broad public investor interest. The transaction normally will be large enough to justify the burden involved. Furthermore, D and S will have been complying with the SEC filing requirements and should have less difficulty in preparing a full disclosure document than if D were a non-registered company.

The hardest case arises where D is not a registered company and the acquisition is insignificant to S. While the public at large and the S shareholders may have no special interest in the transaction, it will always be material to the D shareholders. It is suggested that S should not be required to file anything for this type of acquisition, except a

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[65] For a description of the various categories of information and how they are, or are not, kept current, see *Reform* 1045-47.

brief notice about the transaction and stating the consideration being paid.[66]

As noted above, filing requirements provide benefits which must be weighed against the burdens involved. Ideally a full disclosure document would be available to every D shareholder who is offered S stock in an acquisition, even if D is a one-man company, but the burdens in such a case outweigh the benefits. The line must be drawn at some point. It is suggested that the burden on S of a full dress filing should be eliminated for the insignificant acquisition of any unregistered company. However, it is recognized that some of the reasons given below are more applicable to private D companies, and that possibly some middle ground should be created for a defined category of "public" unregistered companies—for example, those with more than 200 stockholders of record.

If D is not a registered company, then a full-dress disclosure filing covering either company should not be required. First, to prepare such a filing *concerning D* would involve a considerable burden, approaching the burden of preparing a prospectus for the first public offering by D. The transaction is likely to be a relatively small one in relation to the expense and delay involved. D's stockholders have been satisfied with their investment in the past without benefit of information filed with the SEC, and they would not have such information about their own company if they were to sell D stock for cash. There being a relatively small group of D stockholders, they can rely to some extent on their own management to protect them, especially if D is privately owned. Other applicable principles requiring disclosure[67] may well impose obligations on D's management to inform the D stockholders fairly about the transaction,[68]

[66] The suggestion for this brief notice filing derives in part from the proposal that the filing should serve as the registration statement required by the 1933 Act. *See* text accompanying notes 71-81 *infra*. If the suggestion for a simple notice-of-the-event filing is not followed, some other means must be found to satisfy the requirements of the 1933 Act. One possibility would be a definitional rule providing that the issuance of a limited amount of stock by S to a limited class of persons (namely, D or D's stockholders, depending on the form of the acquisition) does not involve a public offering within the meaning of § 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1964).

In any event, if the transaction takes a stock-for-stock form which requires S to make an offer directly to the D shareholders, the notice filing might also contain information on the exchange itself, such as the exchange ratio.

[67] Particular reference is made to Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1964), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1968). Since an acquisition involves a sale of S stock (see note 73 *infra*), liabilities may also arise under Securities Act of 1933 § 17, 15 U.S.C. § 77q (1964). *See generally,* Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied,* 389 U.S. 970 (1967); Lockwood, *Corporate Acquisitions and Actions Under Sections 10(b) and 14 of the Securities Exchange Act of 1934,* 23 BUS. LAW. 365 (1968). Defrauded D stockholders may have additional rights arising under state law.

[68] Most acquisitions, particularly those in the merger or stock-for-assets form, require D to communicate with its own shareholders. The general prohibitions against fraud would impose certain duties on D's management to give D shareholders in-

even if there are no substantive SEC filings required of S. Finally, the D management, which needs no disclosure from S about its own company, normally will have the control position to assure completion of the transaction. Thus, the other D stockholders usually do not have the choice of retaining an investment in D, their only alternatives being to accept S securities in exchange or to liquidate their investment (either by selling the S security or by exercising appraisal rights).

Second, there is already a reservoir of filed information *concerning S.*[69] Balancing all the equities, I would not impose additional filing requirements on S, except for the very simple notice filing. If S issues stock that is being listed on an exchange, it is possible that the same document, with appropriate cover pages, can serve as the listing application and the SEC filing. D can, of course, contract for additional disclosures—for example, a representation by S that its SEC filings contain complete and accurate information (either as of the filing date or as of the current date). Furthermore, D presumably will consult S's SEC filings. If they were filed in a materially deficient manner, D would have various bases for imposing liability on S.[70]

Thus, an SEC filing generally should be required in connection with acquisitions, and the substance, not the form of the transaction should determine whether the filing required, if any, is a brief notice or a full-dress comparative document on both companies.

B. The Nature of the Filing

We have now to consider how the disclosure requirements outlined above fit into the statutory framework of the securities acts. Although the statutes supply alternative bases for such requirements, the choice is an important one since the answers to other questions (concerning resales of shares and liability for misstatements in the filings) will turn on it. The current approach, it will be remembered, is to view all acquisitions involving S stock as "sales" of S stock for nearly every purpose except one under the 1933 and 1934 Acts.[71]

formation free of misstatements or omissions of material facts necessary to make those statements that are actually made not misleading. These provisions may well impose duties of affirmative disclosure on certain topics, such as special benefits which may give D's management conflicting interests in expressly or impliedly recommending favorable action on the acquisition by D's stockholders.

[69] As noted in the text, this analysis assumes generally that S is a registered company. If S is not a registered company, it should make a somewhat fuller disclosure under the 1933 Act, unless some exemption applies.

[70] *See* note 67 *supra*. Securities Exchange Act of 1934, § 18, 15 U.S.C. § 78r (1964), also provides liability for misstatements in documents filed with the Commission.

[71] For example, a rule 133 transaction may involve a "sale" for purposes of the anti-fraud provisions and the 1934 Act short-swing profit recapture provision, Securities Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1964). *See generally* 1 Loss 524-28; Lockwood, *Corporate Acquisitions and Actions Under Sections 10(b) and 14 of the Securities Exchange Act of 1934*, 23 BUS. LAW. 365, 370-71, 372-74 (1968).

The principal if not the sole exception is that transactions in a form covered by rule 133 are treated as no-sale transactions for the limited purpose of 1933 Act section 5,[72] the registration requirement.

It is suggested that the present "no-sale" approach be modified. All acquisitions should be treated as "sales" for purposes of section 5. Registration under that section should be required in all cases, except where D is closely owned and the private offering exemption can be applied.[73] It should be noted that, regardless of its classification as a "sale" or a "no-sale," nearly every acquisition requires some communication to D stockholders, since they must take some individual action—either a vote (in a merger or stock-for-assets acquisition) or a decision to exchange their shares (in a stock-for-stock transaction).

In light of the foregoing, it is suggested that any filing required of S, however limited or extensive it may be, should be treated as a 1933 Act registration statement,[74] except in cases where it is appropriate to apply the private offering exemption because of the limited number of D shareholders. The document which goes to the D stockholder, or at least a part of the document which contains information within the knowledge of S, should be treated as the 1933

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[72] Securities Act of 1933 § 5, 15 U.S.C. § 77e (1964); *see* Securities Act of 1933 § 2(3), 15 U.S.C. § 77b(3) (1964).

[73] Nothwithstanding the lineage of the no-sale analysis, I believe rule 133 has proven to be a sufficiently unsatisfactory underpinning for the law of acquisitions that the Commission would be justified in abandoning this rule in its present form with respect to mergers and stock-for-assets acquisition transactions.

It is interesting to note the metamorphosis of the no-sale doctrine. Today we tend to focus on rule 133 as dealing principally with the subject of *resales* of S stock by former D shareholders, a subject beyond the original scope of the doctrine. Its original focus was on quite a different problem—whether the mere making of the acquisition agreement, including the mechanics of the D shareholder vote, required 1933 Act registration in and of itself. Other possible solutions to this problem are discussed in note 74 *infra*. The tortuous history of the no-sale doctrine is summarized in 1 Loss 518-42; Cohen, *Rule 133 of the SEC*, 14 RECORD OF N.Y.C.B.A. 162 (1959).

Many of the difficulties inherent in treating mergers and stock-for-assets acquisitions as "sales" for purposes of 1933 Act § 5 are discussed in Throop, *In Defense of Rule 133—A Case for Administrative Self-Restraint*, 13 BUS. LAW. 389 (1958). Some of the most difficult problems, relating to civil liability, cannot be avoided entirely merely by retaining the no-sale approach for purposes of 1933 Act § 5, since civil liability can arise under the anti-fraud provisions of rule 10b-5, Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967), or under the proxy rules, J. I. Case Co. v. Borak, 337 U.S. 426 (1964).

[74] In the normal case, the acquisition transaction is negotiated and signed before the SEC filing is prepared and before the individual stockholder action is requested and might therefore be viewed as a sale without proper disclosure, in violation of Securities Act of 1933 § 5, 15 U.S.C. § 77e (1964). Certainly the Commission has the ingenuity and authority to define terms and adopt rules so that the making of the agreement itself will not violate § 5 of the 1933 Act. For example, consistent with the statutory pattern, the basic acquisition agreement may be considered to be a binding pre-effective underwriting agreement, or possibly a transaction which does not, in and of itself, involve any public offering. *See* Securities Act of 1933 §§ 2(3), 4(2), 15 U.S.C. §§ 77b(3), 77(d)(2) (1964). Apparently a workable accommodation has been found in the past to solve the § 5 dilemma. Many registered stock-for-stock acquisitions involve an agreement by the major D shareholders before the registration statement becomes effective, without tainting all such shareholders as statutory underwriters who can never resell without registration.

Act prospectus. The same document (with minor modifications as necessary) may also constitute the proxy statement for either company if a proxy statement is required. The SEC has ample administrative authority to promulgate 1933 Act registration statement and prospectus forms which would fit such a pattern.[75]

To the extent that the required filing is considered a 1933 Act registration statement, stock issued in an acquisition would be "registered" upon issuance. Such a system would simplify the problems raised by resales of S stock by the former D stockholders, a subject considered in detail below. However, as part of a program to rationalize the law, it is not critical to determine the Act under which the filing is made in order to deal with the two other problem areas discussed herein—namely, the extent of disclosure to be required about the acquisition itself and the restrictions on resales of S stock by D shareholders. Even if we continue to characterize mergers and stock-for-assets acquisitions as no-sale transactions (with respect to the issuance of stock in the acquisition), such characterization should not control the result in dealing with the other two problem areas. If an across-the-board 1933 Act approach presents too many difficulties, such as overly burdensome liability problems, the required filing can be treated as a 1934 Act report or proxy statement in appropriate cases.

Regarding liability problems, if a disclosure filing covers information about S and D, each company should generally assume primary responsibility for its own material. To the extent that information in the 1933 Act registration statement relates to S, S should accept the absolute liabilities imposed by the 1933 Act for material deficiencies in the disclosure.[76] However, it would be unduly burdensome to make S absolutely liable for the sufficiency of the disclosures about D which D supplies. As a solution consistent with

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[75] Securities Act of 1933 § 7, 15 U.S.C. § 77g (1964), provides that the registration statement shall contain the information contained in Schedule A to the 1933 Act, "except that the Commission may by rules or regulations provide that any such information . . . need not be included in respect of any class of issuers of securities if it finds that the requirement of such information . . . is inapplicable to such class and that disclosure fully adequate for the protection of investors is otherwise required to be included within the registration statement." *Id.* § 10(a)(4), 15 U.S.C. § 77j (a)(4), gives the Commission express power to omit from the prospectus any information required in the registration statement "which the Commission may by rule or regulation designate as not being necessary or appropriate in the public interest or for the protection of investors."

The Commission's past practice indicates its view that it has the power to establish categories for which the registration statement need not include the full range of information covered by Schedule A to the 1933 Act. *See, e.g.*, SEC Form S-7, 17 C.F.R. § 239.26 (1968); SEC Form S-8, 17 C.F.R. § 239.166 (1968), SEC Form S-9, 17 C.F.R. § 239.22 (1968). The difference in wording between § 7 and § 10(a)(4) seems to reflect the intention of Congress that differences in registration forms be based on broad classifications.

[76] *See* Securities Act of 1933 § 11, 15 U.S.C. § 77k (1964).

current practice in mergers and exchange offerings, S should be able to preface the disclosures about D with a disclaimer such as:

> The following information about D has been supplied by D. S does not know or have reason to know [77] of any material misstatement in this information or of any omission to state a material fact required to be stated herein or necessary to make the statements made herein not misleading in any material respect.

Unless the statement in the disclaimer is untrue, S should not be liable for deficiencies in material supplied by D. On the other hand, consistent with existing practice, responsibility under the 1933 Act might be imposed on D and its controlling persons for the information D supplies.[78]

Acquisitions generally present liability problems distinct from other types of transactions. There may be more hazards in preparing a merger proxy statement or exchange offer prospectus than in preparing a conventional prospectus. Normally, the conservative, cautious course to follow in preparing a prospectus is to resolve all doubts against the issuer and to accentuate the unfavorable aspects. However, in a document being used to compare the two companies, the overly cautious approach presents different hazards. If the document on the acquisition describes either company in an unduly pessimistic light, the transaction may look unduly attractive to its stockholders. Courts should appreciate the dilemma faced by parties preparing filings and should sustain the adequacy of any filing prepared

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[77] By adding the "reason to know" clause, an appropriate duty can be imposed on S to investigate with respect to D. Query whether the duty to investigate D which is imposed on S and its directors, officers and controlling persons should rise to the level of care generally imposed in connection with the conventional public offering. *See* Escott v. BarChriss Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). It might be appropriate for the SEC to adopt rules spelling out these duties in connection with acquisitions, and the standards of care necessary to avoid liability.

It seems preferable to require S to include information to the best of its knowledge, with a protective disclaimer, rather than to allow omission of the information on the ground that S cannot obtain it with certainty. *Cf.* SEC Rule 409, 17 C.F.R. § 230.409 (1968).

[78] D may be classified as an "underwriter" of the S shares being issued, and as such would be liable for registration statement deficiencies by virtue of Securities Act of 1933 § 11(a)(5), 15 U.S.C. § 77k(a)(5) (1964). Controlling persons of underwriters liable under § 11 are themselves liable under Securities Act of 1933 § 15, 15 U.S.C. § 77o (1964).

It may be said that the right of D stockholders to receive S stock is a "security" of which D is the issuer. For other hybrid situations, see (1) SEC Rule 140, 17 C.F.R. § 230.140 (1968), which provides that, under specified circumstances, if X sells securities to invest the proceeds in the securities of Y, Y must join in filing the registration statement as a co-registrant; (2) the treatment of municipal industrial revenue bonds, SEC Rule 131, Securities Act Release No. 4921 (Aug. 28, 1968); (3) the situation with respect to warrants issued by controlling persons, SEC Securities Act Release No. 4666, § 29 (Feb. 7, 1964); SEC Securities Act Release No. 3210 (April 9, 1947); and (4) the situation with respect to variable annuities, SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959).

in good faith which describes each company in a reasonable manner.[79] In connection with acquisitions, it might be appropriate for the SEC to adopt rules spelling out standards of care required by directors, officers and controlling persons in order to avoid personal liability, especially in investigating the other company.

C. Resales of Shares Issued in Acquisitions

If the approach suggested earlier is accepted, every acquisition will produce whatever disclosure filing is necessary to inform the investing public about the effect of the acquisition on S.[80] The filing normally will be a 1933 Act registration statement, and thus the original issuance will be a registered transaction unless an exemption is relied on. Under these circumstances, the 1933 Act would not seem to compel any further restrictions on resales following a bona fide distribution of S securities to the D stockholders in an acquisition transaction.[81]

It is important, however, to consider the public purpose which might be served by restricting resales of the S shares issued in the acquisition. As a result of the acquisition, there may be a temporary disruption of the trading markets, since many of the new shareholders may want to dispose of their S shares. Potential buyers may be exposed to extra selling pressure created for the sale of these shares. For these reasons, it may be appropriate to require delivery of a disclosure document to purchasers. A restriction on resale may also serve as an enforcement aid, to impose restraints on improper selling activity during the period when the market is unsettled.

To the extent that a disclosure document can be delivered to the ultimate purchaser, he may get valuable information of two types. First, he will be informed about S, the company in which he is making

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[79] The Fourth Circuit in effect followed this approach in Walpert v. Bart, 390 F.2d 877 (4th Cir. 1968), in which the court sustained the adequacy of an S proxy statement against the challenge of an S stockholder that the proxy statement was false and misleading. The plaintiff had challenged the proxy statement on two grounds: (1) it presented S in too unfavorable a light because it failed to describe S's favorable cash flow; and (2) it described D in an unduly favorable light in failing to comment on the adverse effects on D's business of a tight money market.

[80] If S makes a series of insignificant acquisitions which are material in the aggregate but do not require filings per se, an upgraded system of 1934 Act reports should produce a filing to describe the resulting impact on S.

[81] The 1933 Act

> does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering. It carefully exempts from its application certain types of securities and securities transactions where there is no practical need for its application or where the public benefits are too remote.

H.R. REP. No. 85, 73rd Cong., 2d Sess. 5 (1934).

an investment. Second, he may be advised (if such is the fact) that extra compensation is being paid as an incentive to sell the shares in question, a factor relevant in evaluating the salesman's recommendation.[82]

Overall, there would not seem to be a pressing need for extensive restrictions on the resale by the former D shareholders of the S shares issued to them in an acquisition. This is especially true if the issuance in the acquisition is cast as a registered transaction. The 1933 Act requirements can be considered satisfied, and the distribution complete, when the D shareholders receive the S stock. On the other hand, if the transaction itself produces a disclosure filing that is readily available, there is relatively little burden in a workable requirement for the delivery of such a document. Balancing all of the considerations, restrictions on resales, if any, should be limited in three respects:

1. The restriction should be designed to cover "distributions" involving extra sales efforts that might distort the trading markets, as contrasted with transactions that might be characterized as routine brokerage or trading transactions.[83] The restrictions on resale should not apply to routine unsolicited brokerage transactions of the type described in rule 133(d) and (e).

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[82] The general subject of sales compensation is an extremely complex one. A broker may expend considerable selling effort on a large block transaction, and consider himself well paid, for an effective commission far *less* than the standard New York Stock Exchange round lot commission. *See* SEC Securities Exchange Act Release No. 8239 (Jan. 26, 1968). There may also be instances where the brokerage *firm* receives only the customary rate of compensation, but the *salesman* receives extra compensation from his firm to sell the particular shares.

Even full compliance with the present law may not necessarily bring home the selling compensation factor to the investor. Indeed, he may be told that he is buying the shares on a "net" basis, and may well assume that he is getting a bargain, although the salesman may be earning substantially more than the ordinary compensation as an incentive to push the shares in question.

[83] "[T]he [1933] Act is, in the main, concerned with the problem of distribution as distinguished from trading." H.R. REP. No. 85, 73d Cong., 1st Sess. 15 (1933). The Commission generally uses "distribution" under the 1933 Act in the sense indicated in the text above. *See, e.g.,* SEC Securities Release No. 3525 (Dec. 22, 1954) (relating to rule 154); SEC Securities Release No. 3965 (Sept. 15, 1958) (relating to rule 133).

On the other hand, the Commission sometimes uses "distribution" in a 1933 Act context to describe transactions which do not involve any unusual selling effort and which are handled in the most routine manner as open market trading transactions. Thus, if an investment purchaser immediately resells his stock (absent a change of circumstances), the Commission will characterize him as an "underwriter"—which necessarily implies that his sale of shares involves a "distribution"—even if the sale is handled as a routine brokerage transaction. *See* Securities Act of 1933 §2(11), 15 U.S.C. §77b(11) (1964).

To some extent, the term "distribution" as used in the text above has a connotation similar to that which it has under 1934 Act SEC rule 10b-6, 17 C.F.R. §240.10b-6 (1968). It is clear, however, that the usage of the term under the two acts is not identical, although it has never been defined with precision in either context. Thus, a major selling effort relating to outstanding stock owned by a non-controlling person may constitute a distribution under rule 10b-6, even though no distribution is taking place under the 1933 Act. *E.g.,* Bruns, Nordeman & Co., 40 S.E.C. 652 (1961); Whitney, *Rule 10b-6: The Special Study's Rediscovered Rule,* 62 MICH. L. REV. 567, 573 (1964).

One may question whether it is desirable to put any numerical limitation (such as the rule 133 one per cent limitation or four-week trading volume tests) on the volume of routine brokerage sales to be permitted. Normally, the restricted seller's own self-interest will cause restraint in the volume of his sales. The seller himself will suffer if he allows his own sales pressure to create an undue price decrease. This is not a circumstance where the individual involved will have an advantage over the public unless his trading is restricted. While the individual may know more about the resulting company, especially if the acquisition was significant, he would rarely be selling on undisclosed *adverse* information; and if he were selling on the basis of material adverse information not known to the public, he might well incur liability under rule 10b-5. Furthermore, if a prospectus delivery is required with respect to any routine brokerage transactions over the limit, it will almost always be honored in the breach (or satisfied by a largely ineffective delivery to an exchange) because of the practical difficulties of compliance.

The use of a numerical limitation will force a choice between two undesirable alternatives. If each restricted individual is entitled to sell up to the limit, then the total number of restricted shares which may be sold will vary depending on the number of restricted holders, a factor not totally relevant to the objectives of the limitation. On the other hand, to lump restricted holders together is to require more fishing in the present sea of uncertainty in trying to determine what sellers must be combined, and inevitably certain hardships will be imposed on individuals caught within the net.

If, nonetheless, there are to be numerical limitations on sales through routine brokerage transactions, certain modifications of the present rule 133 pattern can be suggested for consideration. With respect to over-the-counter securities, where there is no trading-volume information available, the number of shares permitted to be sold might be more appropriately related to a percentage of the estimated floating supply than to the total number of shares in the class outstanding. (Possibly the same change should be made for exchange-traded securities as well.) The floating supply can be defined, for example, to exclude shares held beneficially by directors, officers and ten per cent stockholders and their affiliates and associates.[84] Furthermore, the

[84] The American Stock Exchange makes a similar calculation in eliminating "non-public shares" to determine whether there is an adequate floating supply to meet its listing requirements—except that it refers to controlling stockholders instead of 10% stockholders. *See* Listing Form K, Item 5. It may sometimes be difficult to establish with precision the holdings of associates or affiliates. On the other hand, the beneficial ownership of the individual insiders standing alone may indicate only a small portion of the amount of shares which they control. For example, Mr. Edgar Bronfman recently claimed that his family controls nearly 900,000 shares of Metro-

"bootstrap" element in the present rule 133 might be eliminated. Under the present rule, sales by the restricted seller himself count in the trading volume against which the numerical test is applied during the four subsequent weeks.[85] Finally, there should be no need to reduce the permitted open market sales, as is now done, by the number of shares sold otherwise than pursuant to the open market leakage provision itself.[86] If any of the foregoing modifications of the rule 133 pattern are made, it might be appropriate to raise the limit above the current one per cent level.

Even if the 1933 Act registration requirements are relaxed on resale of S stock by D stockholders, the 1934 Act prohibitions on market manipulations by any group of D stockholders acting in concert should remain.[87]

2. If there are to be restricted sellers, there should be some reasonable certainty in identifying the persons restricted. The present "control" standard (even as commonly misinterpreted[88]) is too vague to be workable for this purpose. It might be sufficient to limit the group to all or some of the categories of persons covered by the management transaction item of the proxy statement.[89]

Goldwyn-Mayer stock. *See* Wall Street Journal, April 29, 1968, at 5, col. 1; Wall Street Journal, April 26, 1968, at 8, cols. 3-4. However, the most recent proxy statement (there being no intervening ownership reports filed by Mr. Bronfman) reports his beneficial ownership as less than 50,000 shares and discloses somewhat more than 500,000 additional shares as being owned by related trusts or corporations. There is no indication of who owns the more than 300,000 shares necessary to make up the 900,000 shares claimed. *See* MGM proxy statement of November 10, 1967.

Since the holdings of insiders can fluctuate, in the interests of certainty it may be appropriate to determine the amount at stated intervals. For example, the issuer could be required to compute the floating supply, as defined, twice a year for the benefit of restricted holders.

[85] Rule 133(d)(3)(B)(ii).

[86] Rule 133(d)(3) reduces the number of shares which a restricted person may sell by *all* other sales of the same class of securities within the preceding six months. Thus, even sales which are registered or exempt under Regulation A reduce the number of shares which may be sold under rule 133. Even private placements, which presumably do not affect the trading market at all, are counted as part of the rule 133 allocation.

[87] SEC Rule 10b-6, 17 C.F.R. § 240.10b-6 (1968); SEC Securities Act Release No. 4371 (June 7, 1961) (Hazel Bishop, Inc.); SEC Securities Act Release No. 4401 (Aug. 3, 1961).

[88] The present rule 133 restricts sales by an "affiliate" of D. The term "affiliate" includes "a person controlling, *controlled by or under common control with* . . ." D. Rule 133(f) (emphasis added). SEC Rule 405(f), 17 C.F.R. § 230.405(f) (1968) defines "control."

Rule 133 is generally characterized by even the most authoritative commentators to restrict only persons *controlling* D. Cohen, *Rule 133 of the SEC*, 14 RECORD OF N.Y.C.B.A. 162, 179 (1959). Little, if any, recognition is ever given to the other categories of "affiliates." However, under the definitions, the rule may also impose restrictions on many employee-shareholders and other persons who are in the "controlled by" rather than the "controlling" category of "affiliate."

[89] SEC Regulation 14A, Schedule A, Item 7(f), 17 C.F.R. § 240.14A (1968), requires disclosures of transactions with directors, officers, beneficial owners of more than 10% of the outstanding voting securities, and "any relative or spouse of any of the foregoing persons, or any relative of such spouse, who has the same home as such person or who is a director or officer of any parent or subsidiary of the issuer."

3. The restrictions on resales should apply for a limited period of time, such as six or nine months. The limitations should apply only until the shares presumably have "come to rest in the hands of the investing public" [90] and the immediate effect of the acquisition on the trading market can be presumed to have been dissipated in the normal circumstance. Thereafter, there should be no further 1933 Act restrictions on resale in the hands of the former D stockholder, unless he has assumed a control relationship with respect to S.

In determining the cutoff point for the restrictions on resale by D stockholders, it is relevant to note that there is no generally applicable 1933 Act registration requirement for "secondary distributions" by non-controlling persons.[91] Perhaps this is a deficiency in the law, and there should be some requirement for disclosures accompanying secondary distributions. However, pending a general change in the law, and balancing all of the equities, there would appear to be no justification for singling out one class of secondary distributors for tougher treatment—namely, former D shareholders who have held their S stock for a respectable period. As noted above, former D stockholders who received S stock in a bona fide acquisition are likely to behave as ordinary investors, in contrast with institutions, investment

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Item 7(f) also covers nominees for election as a director, a category not relevant for this purpose.

Even this standard may not be as definite as it appears. The definitions of "director" and "officer" are broad enough to include, in appropriate circumstances, persons who do not necessarily hold the titles. As defined, these terms include persons performing functions similar to the titleholders'. *See* SEC Rule 405, 17 C.F.R. § 230.405 (1968), for a definition of both terms. There are similar definitions under the 1934 Act. See the definition of "director" in Securities Exchange Act of 1934 § 3(a)(7), 15 U.S.C. § 78(3)(a)(7) (1964), and the definition of "officer" in SEC Rule 3b-2, 17 C.F.R. 240.3b-2 (1968). Thus, a dominant person may be a "director" or "officer" under the Act, even if he has never been elected formally to the position. Of course, if the restriction covers securities "beneficially" owned by a specified class of persons, we must also consider the SEC's expanded concept of beneficial ownership.

[90] Lewisohn Copper Corp., 38 S.E.C. 226, 234 (1958). Although it has never defined the concept with precision, the Commission has indicated in several contexts that a distribution is complete and the requirements of the 1933 Act need not apply once the securities have "come to rest." *See, e.g.,* Strathmore Securities, Inc., SEC Securities Exchange Act Release No. 8207 (Dec. 13, 1967) (regulation A offerings); SEC Securities Act Release No. 4708 (July 8, 1964) (foreign offerings); SEC Securities Act Release No. 4434 (Dec. 6, 1961) (intrastate offerings); SEC Securities Exchange Act Release No. 7366 (July 9, 1964) (foreign offerings).

The Commission has made statements such as "[T]he distribution continued until those shares were sold to *public investors,*" Atlantic Equities Company, SEC Securities Exchange Act Release 8118 (July 7, 1967) (emphasis added). *Accord,* Lewisohn Copper Corp., *supra;* SEC Securities Act Release No. 4434 (Dec. 6, 1961). When the SEC refers to "investors" or "public investors" in this context, often in opposition to "conduit," it is clearly referring to investors in the layman's sense—not purchasers locked in for a couple of years because they acquired securities "for investment" with no "view to distribution" within the meaning of the 1933 Act private offering exemption and the definition of "underwriter." Public officials being as human as the rest of us, I suppose the Commission can be forgiven its occasional lapses into English.

[91] As a striking recent example, about 20% of the total outstanding common stock of Shenley Industries was sold by one investment banking firm within five days, with no 1933 Act registration, while the company was the target of an intense fight for control. Wall Street Journal, April 26, 1968, at 5, cols. 2-4.

banking firms, and the other typical classes of sellers who are usually involved in secondary distributions.

Finally, it might be desirable to impose a simple requirement on restricted holders to report their sales after the fact, for example, by filing a report modeled after Form 4.[92] Such reports might help the Commission monitor the flow of shares and serve various other enforcement purposes. They might also be of considerable interest to investors generally, since they reflect an evaluation of S stock by persons who should be in a better than average position to evaluate S's long-term prospects. It is well known that public investors show considerable interest in trading by corporate insiders.[93]

D. The Need for Full Disclosure—by the SEC

The law in this area has reached an intolerable level of uncertainty. This uncertainty arises in large part from the failure of the Commission to make known its interpretative positions, and also from the Commission's flexibility (one is tempted to say, inconsistency) in applying its interpretations. We cannot hope to reduce such a complex body of law to a black-letter code as simple to apply as, say, a multiplication table. On the other hand, members of the public attempting to comply with the law are entitled to a somewhat higher order of predictability than that presently obtaining.[94]

It is difficult if not impossible to plan an SEC-related transaction intelligently, especially in the acquisition area. Far too many problems are approached by the Commission on an ad hoc basis, applying standards which have not been publicly articulated and which often seem to change just when the bar is getting used to them. The practitioner is frequently frustrated by his inability to give definite answers, even on routine transactions. He could well tell his clients that undertaking a project with the SEC is like starting a law suit—

[92] SEC Form 4, 17 C.F.R. § 249.104 (1968), is the monthly insider trading report required of persons subject to Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p (1964).

The SEC already obtains information from selling stockholders in registered secondary offerings. SEC Securities Act Release No. 4666, § 25 (Feb. 7, 1964). Possibly an undertaking to file such reports can be obtained from selling stockholders as a condition to acceleration of the 1933 Act registration statement. *See* note following SEC Rule 460, 17 C.F.R. § 230.460 (1968). Possibly the issuer itself could be required to file such reports, to the best of its knowledge, either as a condition to acceleration, or as a report required under Securities Exchange Act of 1934 § 13a, 15 U.S.C. § 78m(a) (1964).

[93] Over 25,000 subscribers purchase the SEC's official monthly summary of insider trading reports, more than 10 times the number of subscribers to the Commission's daily News Digest. SECURITIES AND EXCHANGE COMMISSION, 33RD ANNUAL REPORT 42, 142 (1967). It is unlikely that more than a very small fraction of the monthly summary subscribers are potential plaintiffs under Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1964).

[94] One recent criminal defendant has made a strenuous, though so far unsuccessful, claim that a certain commonly applied rule is so vague as to be unconstitutional. United States v. Wolfson, Crim. No. 60-720 (S.D.N.Y. 1968).

in either context, it is generally unwise if not impossible for a lawyer to predict with assurance where his client is likely to come out. Lawyers customarily speak of the need to "negotiate" with the SEC in order to establish the application of the law to a client's situation. For reasons spelled out elsewhere, it is often the most sophisticated practitioner who is at the greatest disadvantage in giving his clients workable advice,[95] since he is more likely to know of an unpublished administrative interpretation frustrating action which could be taken as a practical matter with impunity.

The Commission's administration of the 1933 and 1934 Acts is characterized by a high degree of informality. Many of the administrative doctrines are shaped through comment letters to individual issuers, no-action requests, and other informal and essentially private communications. Thus, a great deal of the interpretative law is nowhere reflected in public rules, forms, administrative decisions or even interpretative releases which are discoverable by the reasonably diligent lawyer.

In undertaking its reform program, one may hope that the Commission will eliminate a number of the trouble spots by restructuring the law to moot the problems. On the other hand, the underlying subject being as complex as it is, many difficult interpretative problems are bound to remain. Indeed, any major revision will almost certainly create some new uncertainties of its own. The Commission should give a high priority to eliminating internal inconsistency and informing the public of its positions.[96]

It must be conceded that there is a countervailing policy. To the extent that the law is vague, the Commission has more flexibility in dealing with wrongdoers and adapting to changing circumstances. Some Commission officials, especially those charged with enforcement, feel that rigid rules, which cannot be applied flexibly to take into account all of the surrounding circumstances, may facilitate improper activities. There is some justification for this position. On the other

[95] *Reform* 1044; Kennedy, *The Case of the Scarlet Letter*, 22 BUS. LAW. 23, 31 (1967). As the Commission's Chairman recently stated, "I have a particular fondness for the many decorative curlicues and imaginative interpretations with which [the Securities Act of 1933] has been embellished over the years." Manuel F. Cohen, Speech before the ALI-ABA Conference on Current Problems of Broker-Dealer Regulations, Washington, D. C., June 7, 1968. Unfortunately, the decorative curlicues and imaginative interpretations more often than not restrict or prohibit what the client wants to do. The more sophisticated the practitioner is, the more likely it is that he has become painfully aware of the embellishments.

[96] *See Reform* 1043-45. There are highly irritating instances of inconsistency among the various branches which process filings within the SEC's Division of Corporation Finance. In addition, one often feels that the branches as a group are not fully aware of the positions being taken by the Chief Counsel for the Division, the latter official having primary responsibilty for interpretive opinion and no-action letters. Furthermore, there seems to be a large (and possibly, legally required) gap between the Division as a whole and the Office of Opinion Writing which prepares formal SEC decisions.

hand, a system which is airtight from the enforcer's point of view can be suffocating to the proper business transaction. In accommodating the competing interests, there is a need for far greater predictability and certainty for the benefit of legitimate businessmen who far outnumber wrongdoers, even at the risk of increasing enforcement problems to some small extent.

IV. Conclusion

Acquisitions have presented numerous problems in applying the federal securities acts. The Commission has attempted to deal with these problems largely by manipulating the statutory terms "sale" and "underwriter." The result has been an erratic pattern with respect to the disclosure accompanying the acquisition and also with respect to the resale of S securities by the D shareholders. The form of the transaction has been given unduly critical significance in approaching many of the recurring questions.

In attempting to find better solutions, it should be recognized that bona fide acquisitions are a unique type of transaction. An acquisition may result in the issuance of S securities, but is qualitatively different from an issuance through the conventional underwritten cash offering, or, for that matter, the usual private placement.

It is suggested that the Commission should use its administrative powers to restructure the disclosure forms relating to acquisitions. The disclosure required at the time of an acquisition should depend on the significance of the acquisition to S and on the needs of investors (including both S and D shareholders) for information, rather than on the form of the transaction.

In approaching the problems of resale of S shares by former D shareholders, the presumption should be against stretching the concept of "underwriter" to restrict further resales of the S stock. The distribution of S stock for purposes of the 1933 Act should be considered to be complete when the S shares reach the hands of the D shareholders, except when resales shortly after the transaction take on the characteristics of a "distribution" as the term is used in rule 10b-6, promulgated under the 1934 Act.

The Commission has sufficient administrative authority to solve most of the problems related to acquisitions without the need for statutory amendment. Even if the securities acts must be amended to achieve a perfect solution, the Commission would still be required to design rules and forms to implement the revised statutes. Accordingly, the Commission, as part of its pending disclosure revision project, should give high priority to the many complex problems regarding acquisition transactions.

APPENDIX

Rule 133, 17 C.F.R. § 230.133 (1968) provides:

(a) For purposes only of Section 5 of the Act, no "sale," "offer," "offer to sell," or "offer for sale" shall be deemed to be involved so far as the stockholders of a corporation are concerned where, pursuant to statutory provisions in the state of incorporation or provisions contained in the certificate of incorporation, there is submitted to the vote of such stockholders a plan or agreement for a statutory merger or consolidation or reclassification of securities, or a proposal for the transfer of assets of such corporation to another person in consideration of the issuance of securities of such other person or securities of a corporation which owns stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such other person, under such circumstances that the vote of a required favorable majority (1) will operate to authorize the proposed transaction as far as concerns the corporation whose stockholders are voting (except for the taking of action by the directors of the corporation involved and for compliance with such statutory provisions as the filing of the plan or agreement with the appropriate State authority), and (2) will bind all stockholders of such corporation except to the extent that dissenting stockholders may be entitled, under statutory provisions or provisions contained in the certificate of incorporation, to receive the appraised or fair value of their holdings.

(b) Any person who purchases securities of the issuer from security holders of a constituent corporation with a view to, or offers or sells such securities for such security holders in connection with, a distribution thereof pursuant to any contract or arrangement, made in connection with any transaction specified in paragraph (a), with the issuer or with any affiliate of the issuer, or with any person who in connection with such transaction is acting as an underwriter of such securities, shall be deemed to be an underwriter of such securities within the meaning of section 2(11) of the Act. This paragraph does not refer to arrangements limited to provision for the matching and combination of fractional interests in securities into whole interests, or the purchase and sale of such fractional interests, among security holders of the constituent corporation and to the sale on behalf of, and as agent for, such security holders of such number of fractional or

whole interests as may be necessary to adjust for any remaining fractional interests after such matching.

(c) Any constituent corporation, or any person who is an affiliate of a constituent corporation at the time any transaction specified in pargaraph (a) is submitted to a vote of the stockholders of such corporation, who acquires securities of the issuer in connection with such transaction with a view to the distribution thereof shall be deemed to be an underwriter of such securities within the meaning of section 2(11) of the Act. A transfer by a constituent corporation to its security holders of securities of the issuer upon a complete or partial liquidation shall not be deemed a distribution for the purpose of this paragraph.

(d) Notwithstanding the provisions of paragraph (c) a person specified therein shall not be deemed to be an underwriter nor to be engaged in a distribution with respect to securities acquired in any transaction specified in paragraph (a) which are sold by him in brokers' transactions within the meaning of section 4(4) of the Act, in accordance with the conditions and subject to the limitations specified in paragraph (e) hereof, if such person

(1) does not directly or indirectly solicit or arrange for the solicitation of orders to buy in anticipation of or in connection with such brokers' transactions;

(2) makes no payment in connection with the execution of such brokers' transactions to any person other than the broker; and

(3) limits such brokers' transactions to a sale or series of sales which together with all other sales of securities of the same class by such person or on his behalf within the preceding six months will not exceed the following:

(A) if the security is traded only otherwise than on a securities exchange, approximately one percent of the shares or units of such security outstanding at the time of receipt by the broker of the order to execute such transactions, or

(B) if the security is admitted to trading on a securities exchange, the lesser of approximately (i) one percent of the shares or units of such security outstanding at the time of receipt by the broker of the order to execute such transactions or (ii) the largest aggregate reported volume of trading on securities exchanges during any one week within the four calendar weeks preceding the receipt of such order.

(e) For the purposes of paragraph (d) of this rule

(1) the term "broker's transactions" in section 4(4) of the Act shall be deemed to include transactions by a broker acting as agent for the account of the seller where (a) the broker performs no more than the usual and customary broker's functions, (b) the broker does no more than execute an order or orders to sell as a broker and receives no more than the usual or customary broker's commissions, (c) the broker does not solicit or arrange for the solicitation of orders to buy in anticipation of or in connection with such transactions and (d) the broker is not aware of any circumstances indicating that his principal is failing to comply with the provisions of paragraph (d) hereof;

(2) the term "solicitation of such orders" in section 4(4) of the Act shall be deemed to include the solicitation of an order to buy a security, but shall not be deemed to include the solicitation of an order to sell a security;

(3) where within the previous 60 days a dealer has made a written bid for a security or a written solicitation of an offer to sell such security, the term "solicitation" in section 4(4) shall not be deemed to include an inquiry regarding the dealer's bid or solicitation.

(f) For the purposes of this rule, the term "constituent corporation" means any corporation, other than the issuer, which is a party to any transaction specified in paragraph (a). The term "affiliate" means a person controlling, controlled by or under common control with a specified person.