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Corporate Mergers: The Status of a Dissolving Corporation Shareholder Who Wishes to Sell His Stock under Present and Proposed Rule 133 of the Securities Act of 1933

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Comments

CORPORATE MERGERS: THE STATUS OF A DISSOLVING CORPORATION SHAREHOLDER WHO WISHES TO SELL HIS STOCK UNDER PRESENT AND PROPOSED RULE 133 OF THE SECURITIES ACT OF 1933

From an attorney's standpoint, the increasingly common occurrence of the corporate merger requires a thorough knowledge of the Securities Act of 1933[1] and Rule 133 thereof which grants an exemption from normal securities registration requirements to merging corporations.[2] Knowledgeable representation is especially critical to a domestic close corporation whose shares are owned by a very small number of persons and have been sold in the past completely intrastate without the necessity of filing a registration statement under the Securities Act,[3] and which corporation now wishes to merge into a large public corporation which has participated in interstate offerings in the past, requiring shares registered with the Securities and Exchange Commission.[4] In such a merger the ab-

1. 15 U.S.C. §§ 77a-77aa (1964).

2. 17 C.F.R. § 230.133 (1969).

3. Intrastate offerings are exempt offerings not requiring registration under the Securities Act § 3(a)(11), 15 U.S.C. § 77c (a)(11) (1964). Such exemption requires that the issuer is a corporation, incorporated by and doing business within the same state or territory as that in which the securities are offered and sold to persons resident within said state or territory.

4. The Securities Act § 5(a), 15 U.S.C. § 77e(a) (1964), makes it unlawful "to make use of any means or instruments of transportation or commerce in interstate commerce or of the mails" to sell any security, whether by means of a prospectus or otherwise, unless a registration statement, as filed with the Securities and Exchange Commission, is in effect or unless the particular security or transaction falls within one of the

sorbing corporation will generally offer its own unregistered securities in exchange for shares of the dissolving corporation.[5] The problem confronting the receiving shareholders is whether they must register these shares before selling them.[6]

To best explore the problem with which this Comment is concerned, it is especially helpful to outline a hypothetical situation for reference throughout this Comment. Blackacre, Inc., a Pennsylvania corporation, was incorporated in the early 1950's. It has four shareholders: John Smith, Richard Roe, Mrs. Richard Roe and Mr. and Mrs. Richard Roe, jointly. In a 1969 merger of Blackacre, Inc. with Whiteacre, Inc., the above four shareholders received the following interest in Whiteacre, Inc.: John Smith, 116,000 shares; Richard Roe, 37,000 shares; Mrs. Richard Roe, 41,000 shares; Mr. and Mrs. Richard Roe, jointly, 1,800 shares. Whiteacre, Inc. is a publicly held corporation listed on the New York Stock Exchange. The merger was finalized on October 31, 1969. The total number of shares outstanding in Whiteacre, Inc. is presently 3,221,000.[7]

Applying the existing Rule 133 to the above hypothetical corporation should result in the following procedure, assuming that the shareholders of Blackacre, Inc. wish to sell their newly acquired interests in Whiteacre, Inc. as soon as possible after receipt on the effective merger date. The total shares outstanding in Whiteacre, Inc. on October 31, 1969, the effective date of merger, was 3,221,000. Since Whiteacre, Inc. is listed on the New York Stock Exchange, the one per cent (1%) quantitative "rule of thumb" defined in Rule 133 (d) (3) (B)[8] would be applied. One per cent (1%) of 3,221,000 shares is 32,210 shares. Taking into consideration that jointly held shares are considered owned by both parties for compu-

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exemptions enumerated in the Securities Act §§ 3, 4, 15 U.S.C. §§ 77c, 77d (1964).

In the hypothetical case used in this Comment, it is assumed that Whiteacre, Inc. fell within the regulation of § 5 of the Securities Act by reason of its interstate sales of securities in the past.

The Securities and Exchange Commission is hereinafter also referred to as the S.E.C.

5. *See* CONCLUSION, p. 437 *infra*. The absorbing corporation will normally want to avoid registration in a merger situation because of the expense involved in the filing of a registration statement, and registration does not really enhance its own position, just that of the new shareholders.

6. If a shareholder's shares require registration before sale, the individual shareholder would most probably be faced with more expenses and legal fees than profit made.

7. The facts used in the hypothetical fact situation are extracted from an actual merger. The names of the corporations and shareholders are fictional, and the numbers of shares have been rounded to the nearest thousand.

8. 17 C.F.R. § 230.133 (d) (3) (B) (1969).

tation purposes (a situation affecting the Roe shares),[9] on April 1, 1970, six months after the effective date of the merger, John Smith, Richard Roe, and Mrs. Richard Roe can each sell through broker's transactions the lesser of the following:

1. One per cent (1%) of the shares of such securities outstanding which equals 32,210 shares; or
2. The largest aggregate reported volume of trading on securities exchanges during any one week within the four calendar weeks preceding the receipt of such an order.

Because of its broad nature, it is impossible to set a numerical figure for the second option until immediately prior to April 1, 1970.

This Comment will analyze the present "no sale" theory under Rule 133 as it applies to the above hypothetical fact situation and compare it with the S.E.C.'s proposed change of said Rule and the promulgation of several new rules which will correlate with Rule 133.

Rule 133 As It Presently Exists

Since 1967, the S.E.C. has held that if the transfer of the public corporation's shares to the shareholders of the dissolving corporation was structured otherwise than as a merger or sale of assets (to which Rule 133 would apply), such a transaction is a private placement.[10] A private placement refers to the section 4(2) exemption of the Securities Act[11] involving "a transaction by an issuer not involving any public offering."[12] Since a private placement is also an exemption from the registration requirements, one might immediately ask whether there is a problem. However, the private offering exemption is lost if the number of receiving shareholders is large (a general rule of thumb is more than 25), or the receiving shareholders do not have access to all the information normally contained in a registration statement or receive said shares with "a view toward distribution" rather than with an investment interest.[13] Therefore, a private placement is generally limited as to the number of receiving shareholders, but more importantly, it is subject to the same "view to distribution" limitation inherent in Rule 133[14] without the quantitative, one per cent "out" allowed by Rule 133.[15]

9. *See, e.g.*, 17 C.F.R. § 241.7793 (1969). Generally, a person is regarded as the beneficial owner of securities held in the name of his or her spouse and their minor children.

10. S.E.C., Disclosure to Investors—A Reappraisal of Administrative Policies Under the '33 and '34 Acts [hereinafter cited as the Wheat Report], S.E.C. Securities Act Release No. 4963, CCH Fed. Sec. L. Rep., The Wheat Report 266 (1969). All citations to the Wheat Report in this Comment will be to the CCH complete text of same.

11. 15 U.S.C. § 77(d)(2) (1964).

12. *Id.*

13. 17 C.F.R. § 231.4552 (1969).

14. *See A Rule 133 Underwriter*, p. 426 et seq. *infra*.

15. 17 C.F.R. § 230.133(d)(3)(B) (1969).

The position of the S.E.C. exemplifies one of the principal inconsistencies created by Rule 133. If Whiteacre, Inc. wishes to acquire Blackacre, Inc. through a voluntary exchange of shares, "*all* the former shareholders of Blackacre, Inc. must take their new shares subject to severe restrictions on resale if Whiteacre, Inc. is to claim the 'private offering' exemption from registration."[16] However, if the structure of the transaction can be worked into that of a statutory merger or sale of assets whereby the merging corporation is completely liquidated under applicable state statutes, to which Rule 133 applies, then the restrictions on resale affect *only* the controlling shareholders of Blackacre, Inc.[17] As such, all restrictions and qualifications under Rule 133 apply only to controlling shareholders; noncontrolling shareholders are free to trade the unregistered securities. The obvious question is whether such a distinction is justified.[18]

Generally, section 5(a) of the Securities Act[19] makes it unlawful "to make use of any means or instruments of transportation or commerce in interstate commerce or of the mails" to sell any security, whether by means of a prospectus or otherwise, unless a registration statement, as filed with the S.E.C., is in effect or unless the particular security or transaction falls within one of the exemptions enumerated in sections 3 and 4 of the Securities Act.[20] As such, only intrastate oral communications do not fall within the coverage of section 5(a), noting of course the enumerated exemptions, and it would seem that the offering of shares in the manner of a corporate merger would constitute the prohibited conduct.

However, in Rule 133 of the Securities Act, the S.E.C. announced an exception to section 5(a) of the Securities Act with the promulgation of what has been termed the "no sale theory."

> No "sale," "offer," "offer to sell," or "offer for sale" shall be deemed to be involved so far as the stockholders

16. WHEAT REPORT at 266.
17. WHEAT REPORT at 267 et seq.
18. *See* text accompanying notes 103 and 104 *infra.*
19. Securities Act § 5(a) provides:

> Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—
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> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

15 U.S.C. § 77e(a) (1964).
20. 15 U.S.C. § 77c (1964) and 15 U.S.C. § 77d (1964).

> of a corporation are concerned where, pursuant to a statutory provision in the state of incorporation or provisions contained in the certificate of incorporation, there is submitted to the vote of such shareholders a plan or agreement for a statutory merger or consolidation or reclassification of securities, or a proposal of or 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 . . . 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.[21]

The essence of this rule seems to be that if a corporation is liquidated and merged or consolidated with another corporation under applicable state statutory provisions and if said corporation receives the consent of the specified number of shareholders to such action, then no "sale," "offer," "offer to sell," or "offer for sale" will be deemed to exist so as to require registration of the shares prior to the merger transaction. It must be emphasized that Rule 133 only applies to the distribution of Whiteacre, Inc. stock to the former Blackacre, Inc. shareholders at the time of the merger. *It does not cover the subsequent distribution of securities received by a security holder under the terms of the merger or consolidation.* The rule is designed solely to exempt the merger transaction itself from the registration requirements of section 5(a) of the Securities Act, even if such a transaction takes place through the use of interstate commerce or through the mails.

In the past, the S.E.C. based its Rule 133 position on the theory that no sale to individual stockholders exists where their vote authorizes a merger since the transfer is a result of corporate action and not individual consent.[22] However, in a closely held corporation with a small number of shareholders, the corporate action is normally only a matter of course and in reality the consent of individuals.

Even though the transfer from the issuer to the shareholders of the merged corporation is not subject to registration, the receiver is not necessarily free to sell his stock. "Unless the Securities Act provides an exemption for a subsequent sale of such nonregistered stock, registration would be required."[23] The exemp-

21. 17 C.F.R. § 230.133(a) (1969).
22. Great Sweet Grass, 37 S.E.C. 683 (1957).
23. *Id.*

tion can take the form of either an "exempted security" or an "exempted transaction."[24] Exempted securities are those which never have to be registered, such as any security issued by the federal government, and will not be discussed herein. The exempted transactions[25] are described in section 4 of the Securities Act and unless such exemption applies to the receiver of stock in the described merger, the securities must be registered before they can be traded. Rule 133 offers an "exempted transaction" for stock received in a merger to an "affiliate" of a "constituent corporation"

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24. The "exempted securities" are set forth in the Securities Act of 1933 § 3, 15 U.S.C. § 77c (1964). These exemptions include: securities sold prior to July 27, 1933, securities of government and banks, commercial paper, securities of charitable organizations, securities of building and loan associations and farmers' cooperative associations, securities of a common or contract carrier, receivers' and trustees' certificates, insurance policies and annuity contracts, securities exchanged with security holders, securities issued in reorganizations approved by court or governmental authority, securities issued by small business investment companies and intrastate issues.

The "exempted transactions" are set forth in the Securities Act of 1933 § 4, 15 U.S.C. § 77d (1964):

> (1) transaction by any person other than an issuer, underwriter, or dealer.
>
> (2) transactions by an issuer not involving any public offering.
>
> (3) transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except—
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> (A) transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter,
>
> (B) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under § 8 is in effect as to the security), or such shorter period as the Commission may specify by rules and regulations or order, and
>
> (C) transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter.
>
> With respect to transactions referred to in clause (B), if securities of the issuer have not previously been sold pursuant to an earlier effective registration statement the applicable period, instead of forty days, shall be ninety days, or such shorter period as the Commission may specify by rules and regulations or order.
>
> (4) brokers' transactions, executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders.

25. *Id.*

and will be discussed later in this Comment.[26]

Subsequent *casual* sales of the stock acquired in a merger by non-controlling stockholders[27] which follow the normal pattern of trading in the stock would be deemed exempt from the registration provisions of section 5 of the Securities Act as transactions "not involving an issuer, underwriter, or dealer" under section 4(1) of the Securities Act.[28] However, this exemption is lost if the issuer, *i.e.* Whiteacre, Inc. (or persons acting on its behalf), participates in arranging for a distribution to the public of any of the stock received through the merger or has knowledge of a plan of distribution by, or concerted action on the part of, such stockholders to make a public distribution in connection with the transaction.[29] Under such circumstances, the stockholders would be underwriters as defined in section 2(11) of the Securities Act[30] since they acquired shares from the issuer "with a view to distribution" of said shares.[31] As noted above, distribution of shares by an underwriter requires registration of those shares before they can be traded.[32]

A Rule 133 Underwriter

Section (b) of Rule 133 defines "underwriter" for the purposes of Rule 133 in a manner very parallel to the terms used in section 2(11) of the Securities Act.[33] The importance of the definition is that one who is classified as an underwriter can deal only in registered securities unless falling within one of the specific exemptions.[34]

Rule 133 places the status of an underwriter on two classes of persons: (1) a "constituent corporation" (Blackacre, Inc.) or any person who is an "affiliate" (*e.g.*, John Smith) of a constituent corporation can be classified an underwriter under section (c) of

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26. 17 C.F.R. § 230.133(d) (1969). See text accompanying notes 40-48 *infra*.

27. See notes 40, 41, 42 and 43 and accompanying text *infra* for definition of a "controlling shareholder."

28. 15 U.S.C. § 77d(1) (1964).

29. Great Sweet Grass, 37 S.E.C. 683 (1957).

30. 15 U.S.C. § 77(b)(11) (1964).

31. *Id.*

32. *See* note 28 and accompanying text *supra*.

33. 15 U.S.C. § 77(b)(11) (1964):

> Any person who has purchased from an issuer, with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking. . . . *The term issuer shall include in addition to any issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect control with the issuer.*

34. The reverse logic by which such a conclusion is reached can be understood by reading the Securities Act § 4(2), 15 U.S.C. § 77d(2) (1964), which defines one of the exemptions as "transactions by any person other than an issuer, underwriter, or dealer." Thus, if an underwriter does not qualify for any of the other exemptions, he must deal only in registered shares.

Rule 133 if he "acquires securities of the issuer in connection with such a transaction *with a view to the distribution thereof*,"[35] (2) furthermore, under section (b) of Rule 133 any person who purchases securities of the issuer from security holders of a constituent corporation with a view to distribution thereof can be classified an underwriter.[36] This Comment is concerned primarily with the sale of stock after merger by the first group mentioned.

The subjective nature of the phrase "with a view to the distribution thereof" is an acute factual problem under the present Rule 133.[37] Obviously, everyone intends to sell their shares at some time. Issuers have resorted to using letters of investment intent in the past to try to protect themselves, but this has not been held determinative.[38] If all else fails, the one deciding factor is the time for which the stocks were held prior to redistribution.[39]

To fully understand the above, it is necessary to define several of the terms. As noted above, only a previously controlling stockholder need be concerned with the problems of registration before redistribution, but who is a "controlling person"?[40] The concept of "control" in the Securities Act is not a narrow one, depending upon a mathematical formula of 51 per cent of the voting power, but is broadly defined to permit the provisions of the Act to become effective whenever the *fact* of control exists.[41] A 51 per cent interest is not necessary to be a controlling shareholder.[42] For ex-

35. 17 C.F.R. § 230.133(c) (1969).

36. 17 C.F.R. § 230.133(b) (1969). *See also* Ambrosia Minerals, Inc., 39 S.E.C. 734 (1960).

37. *See* Ambrosia Minerals, Inc., 39 S.E.C. 734 (1960).

38. For a discussion of the problem concerning investment letters *see* WHEAT REPORT, chap. VI, at 171. One could argue that the taking of investment letters is mere ritual, but failure of an issuer to do so might be deemed to evidence a disregard for the purchaser's intent with respect to the securities. *Id.*

39. [As] a practical matter, the shares may . . . 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.

Shneider, *Acquisitions Under the Federal Securities Laws—A Program for Reform*, 116 U. PA. L. REV. 1323, 1337 (1968).

40. The definition of a "controlling person" is necessary to further define "affiliate" as used in Rule 133.

41. H.R. REP. No. 85, 73rd Cong., 1st Sess. 13 (1933).

42. *Id.* The allegation that such a "control" concept is vague and indefinite and therefore in violation of the fifth amendment of the United States Constitution was rejected in 1967 in United States v. Wolfson & Gerbert, 269 F. Supp. 621 (D.C.N.Y. 1967). *Cf.* the specific control interpretations under Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78t (1964).

ample, the Securities Exchange Act defines a person in control as anyone who owns more than 10 per cent of any class of equity security.[43]

A "constituent corporation"[44] is a corporation which is a party to a merger, but is not the issuer of stock, *i.e.* not the surviving corporation, but the corporation whose corporate existence ends with the merger which in the hypothetical would be Blackacre, Inc.[45]

An "affiliate"[46] is a person controlling, controlled by, or under common control with a specified person,[47] *i.e.* a "control shareholder" of Blackacre, Inc. would be an "affiliate" of a "constituent corporation." Upon the facts, any of the three shareholders of Blackacre, Inc., would very probably be viewed by the S.E.C as control shareholders of Blackacre, Inc. (therefore "affiliates" of the "constituent corporation") since: (1) there are only three shareholders; (2) they owned all the outstanding shares in that corporation; (3) the least that any one of the three owned was 20 percent of the outstanding shares.

The "issuer of stock"[48] is the surviving corporation, *i.e.*, Whiteacre, Inc.

Therefore, if John Doe, Richard Roe, or Mrs. Richard Roe received their merger shares from Whiteacre, Inc. with a "view to distribution" or resale of same, as "affiliates" of a "constituent corporation" they would be considered an "underwriter" within the meaning of section (b) of Rule 133 and would be subject to the limitations of an underwriter under the Securities Act. Except to the extent to be described below, the Roes and Mr. Doe would not be able to trade their newly acquired shares until registered by the issuer.

Distribution of Shares Received in Merger-133 Exemption

Section (d) of Rule 133[49] outlines an exemption for "affiliates" of a "constituent corporation" who wish to sell the shares acquired through merger without the necessity of filing a registration statement. Note, no such exemption is required for non-controlling shareholders of the constituent corporation since they would not be an underwriter under Rule 133 and would therefore be free to sell their shares at any time. Controlling shareholders of a "constituent corporation" will not be considered an "underwriter," even if they received stock in the merger "with a view to redistribution," if they resell their newly acquired shares in *brokers' transactions*

43. Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78t (1964).
44. *See* 17 C.F.R. § 230.133(c) (1969).
45. 17 C.F.R. § 230.133(f) (1969).
46. *See* 17 C.F.R. § 230.133(c) (1969).
47. 17 C.F.R. § 230.133(f) (1969).
48. *See* 17 C.F.R. § 230.133(c) (1969).
49. 17 C.F.R. § 230.133(d) (1969).

within the meaning of section 4(4) of the Securities Act[50] and in accordance with the conditions of and subject to the limitations specified in section (e) of Rule 133.[51] The qualifications that such persons must meet require that they: (1) do 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) make no payment in connection with the execution of such brokers' transactions to any person other than the broker; and (3) limit 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 not traded on a securities exchange, one per cent (1%) of the shares or units of such security outstanding at the time of receipt by the broker of the order to execute such transactions, or

(B) If the shares of the issuer are traded on a securities exchange, the *lesser* of approximately

(i) one per cent (1%) of the shares or units of such security outstanding at the time of receipt by the security outstanding at the time of receipt by the broker of the order to execute such transactions *or*

(ii) largest aggregate reported volume of trading on securities exchanges during any one week within the four calendar weeks preceding the receipt of such order.[52]

Analogy to Rule 154 Brokers' Transactions

These quantitative "rules of thumb" are modeled after Rule 154[53] which interprets the exemptions in section 4(4) of the Securities Act[54] for unsolicited brokers' transactions, and many of the interpretations and much of the administrative gloss concerning Rule 154 can be expected to carry over to the newer Rule 133. Brokers' transactions, executed upon customers' orders on any exchange or in the open or over-the-counter market, but not the solicitation of such orders, are exempted transactions under section 4(4) of the Securities Act.[55] The section 4(4) exemption depends

50. 15 U.S.C. § 77d(4) (1964).
51. 17 C.F.R. § 230.133(e) (1969). *See* text accompanying note 69 *infra* for the substance of Rule 133(e).
52. 17 C.F.R. § 230.133(e) (1969).
53. 17 C.F.R. § 230.154 (1969).
54. 15 U.S.C. § 77d(4) (1964); *see* 1 L. LOSS, SECURITIES REGULATION 536 (2d ed. 1961).
55. 15 U.S.C. § 77d(4) (1964).

not upon a firm's generally acting as a broker but upon the capacity in which it executes a particular transaction. The definition of "broker" is not given by the Securities Act or the rules,[56] although it is stated that all brokers are "dealers" within section 2(12).[57]

> The purpose of § 4(4) is to exempt the ordinary brokerage transaction. Individuals may thus dispose of their securities according to the methods which are now customary without any restrictions imposed upon the individual or the broker. This exemption also assures an open market for securities at all times, even though a stop order against further distribution of such securities may have been entered. Purchasers, *provided they are not dealers*, may thus in the event that a stop order has been entered, cut their losses immediately, if there are losses, by disposing of the securities. On the other hand, entry of a stop order prevents any further *distribution* of the securities.[58]

It should be noted that the exemption provided by section 4(4) applies only to the brokers' part of the brokers' transaction. It is up to the broker to question the customer to determine whether or not the customer is an underwriter or other classification which would require registration or subject him to the restrictions as set out above under Rule 133.[59] Both the individual and the broker must be exempt from registration. Normally, an individual would find an exemption under section 4(1) of the Securities Act.[60] The "soliciation" of a *buy order* destroys the exemption, but not the solicitation of a sell order.[61] A broker with a sell order to execute may call another broker or dealer who has inserted a bid for the security or invited offers of it in the daily quotation sheets or by means of any other writings, whether published or not; such an act is considered to be a response to a buying offer. Likewise, a broker executing a sell order on the floor of an exchange is not deemed to be soliciting buy orders when he goes to the post at which the security is traded and executes the order in the normal manner. But if the broker does more, *e.g.* "buttonholes" a member on the floor of the exchange, he loses the exemption.[62] It is a safe assumption that this Rule 154 interpretation also applies to Rule 133(e) (2).[63] Where within the previous sixty days a dealer has made a written bid for a security or a written solicitation of an offer to sell said security, the term solicitation in section 4(4) of the Securities Act shall not be deemed to include an inquiry regarding the dealer's bid or solicitation;[64] *i.e.* a broker is safe if he calls a dealer

56. *See* 1 L. Loss, Securities Regulation 697 (2d ed. 1961).
57. 15 U.S.C. § 77(b) (12) (1964).
58. H.R. Rep. No. 85, 73rd Cong., 1st Sess. 13 (1933).
59. 1 L. Loss, Securities Regulation 698 (2d ed. 1961).
60. 15 U.S.C. § 77d (1) (1964). *See also* Rule 133(e) (2), 17 C.F.R. § 230.133(e) (2) (1969).
61. Brooklyn Manhattan Transit Corp., 1 S.E.C. 147, 171 (1935).
62. 1 L. Loss, Securities Regulation 699 (2d ed. 1961).
63. *See* notes 53-57 and accompanying text *supra*.
64. 17 C.F.R. § 230.154(d) (1969).

who had contacted him within the previous sixty days concerning the issuer's stock and asks the dealer whether he is still interested in buying shares in the issue.

Rule 133 may be further analogized to Rule 154 interpretations by the S.E.C. concerning the extent to which a person who is an affiliate of a constituent corporation may sell his own securities to a broker. The fact that a broker effects an isolated transaction for an affiliate does not make the broker an underwriter even though he is selling for an "issuer" within section 2(11) of the Securities Act,[65] and the affiliate's part in the transaction is exempt within section 4(1) because the affiliate is neither an issuer, an underwriter, nor a dealer.[66] This applies so long as the broker does not exceed normal brokerage functions. What constitutes such is a question of fact.[67] Although a solicitation would normally seem to be part of the normal brokerage function, any solicitation which destroys the 4(4) exemption for the broker's part of the transaction also destroys the 4(1) exemption for the affiliate's part of the transaction.[68] Rule 133(e)(1) defines brokers' transaction as follows:

> The term "brokers' transaction" in § 4(4) of the Securities Act shall be deemed to include transactions by a broker acting as an agent for the account of the seller where
> (a) the broker performs no more than the usual and 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 customary brokerage 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 circumstances indicating that his principal is failing to comply with the provisions of § (d).[69]

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65. 15 U.S.C. § 77b(11) (1964).
66. *See* The Securities Act of 1933 § 4(1), 15 U.S.C. § 77d(1) (1964).
67. *See* 1 L. LOSS, SECURITIES REGULATION 701 (2d ed. 1961).
68. *Id.*
69. 17 C.F.R. § 230.133(e) (1969); *cf.* the definition of brokers' transaction in Rule 154, 17 C.F.R. § 230.154(a) (1969):

> (a) The term "brokers' transactions" in § 4(4) of the Act shall be deemed to include transactions by a broker acting as agent for the account of any person controlling, controlled by, or under common control with, the issuer of the securities which are the subject of the transactions where—
> (1) The broker performs no more than the usual and customary broker's function,
> (2) The broker does no more than execute an order or orders to sell as a broker and receives no more than the usual or customary broker's commission, and the broker's principal, to the knowledge of the broker, makes no payment in connection with the execution of such transactions to any other person,

Rule 133(d)(3)(B) sets the same one per cent (1%) limitation as is present in Rule 154(b).[70] The formula requires the inclusion of *all* sales by or on behalf of the same person within the preceding six months.[71] Thus, sales effected under the first class of section (4)(1) (sales by other than an issuer, underwriter or dealer) even without the use of a broker must be taken into consideration.

It is understood to be the view of the S.E.C. that the rule may not be used as a means of continuous distribution.[72] That is to say, the formula does not necessarily apply if it is contemplated at the beginning that the maximum amount will be sold during one six-month period after another. But the S.E.C. has not always objected to use of the Rule in successive periods.[73] Therefore, it would be advisable that the parties involved not dispose of the maximum amount allowed each six-month period. When several persons together control the issuer, the S.E.C. permits each of them to use the formula during the same six-month period, except when they sell securities which they own jointly or in common or when they otherwise act in concert, perhaps as members of a controlling group knit closely together by a family or other relationships.[74]

The Recommended Revision of Rule 133 By the Securities and Exchange Commission

On October 9, 1969, the S.E.C. issued a release in which it proposed a revision of Rule 133, the rule which presently is authority[75] for the view that no sale to stockholders is involved where the vote of the stockholders as a group authorizes a corporate act such as a merger.[76] The suggested revision would require the application of the registration requirement of the Securities Act to mergers and consolidations in *all* cases in which the dissolving corporation has more than 25 shareholders.[77] In cases of less than 25 shareholders, the transaction would definitely fall within the private offering exemption of section 4(2) of the Securities Act[78] as a consequence

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(3) Neither the broker, nor to his knowledge his principal, solicits or arranges for the solicitation of orders to buy in anticipation of or in connection with such transactions, and

(4) The broker is not aware of circumstances indicating that his principal is an underwriter in respect of the securities or that the transactions are part of a distribution of securities on behalf of his principal.

70. 17 C.F.R. § 230.133(d)(3)(B) (1969); cf. 17 C.F.R. § 230.154(b) (1969).

71. 17 C.F.R. § 230.133(d)(3)(B) (1969).

72. 1 L. Loss, Securities Regulation 705 (2d ed. 1961).

73. *Id.*

74. *Id.*

75. "The Commission . . . shall have power to make such rules and regulations as may be necessary for the execution of the functions vested in them. . . ." Securities Exchange Act § 23, 15 U.S.C. § 78w(a) (1964).

76. 17 C.F.R. § 230.133 (1969).

77. SEC Securities Act Release No. 5012 (October 9, 1969).

78. *See* notes 11-15 and accompanying text *supra.*

of a suggested new Rule 181.[79] In the hypothetical, since Blackacre, Inc. had only three shareholders, the merger transaction would fall within the private offering exemption and all the limitations inherent in such exemption if one or more of the receiving shareholders acquires his shares in Whiteacre, Inc. with "a view to distribution" or acts as a "conduit for a wider distribution."[80] It should be noted that these restrictions apply to all shareholders, not just to controlling shareholders as the present Rule 133. The proposed Rule 133 seems to be nothing more than a crossroads for a merger fact situation; if there are more than 25 shareholders involved, you turn right to the registration requirements; if there are less than 25 shareholders involved, you turn left to the private offering exemption.

The Disclosure Policy Study Report[81] had recommended that Rule 133 be revised to provide that the submission to stockholders of a merger or consolidation proposal, as presently provided for in Rule 133, be "deemed to involve an offering of securities to the security holders of the company being merged or consolidated or whose securities are being reclassified or assets transferred to another person, such that a registration statement covering these offered securities would have to be filed."[82] The philosophy behind this revision is that when such a proposal is submitted to the vote of the shareholders of the corporation being merged (*e.g.* Blackacre, Inc.), the shareholders are being asked to determine whether or not they wish to exchange the securities which they presently hold for new securities. Therefore, the new securities are being "offered" to them as that term is defined in interpretations by the S.E.C. under section 5(a) of the Securities Act.[83]

Practical Effects

Revised Rule 133 would further provide that no offer or sale of a security should be deemed to be involved in sending out a bare notice of a meeting of stockholders for the purpose of voting on a merger proposal provided that a prospectus is sent or given to security holders entitled to vote on the proposal at least twenty days before the meeting date,[84] *i.e.*, notice of the shareholder's meeting

79. S.E.C. Securities Act Release No. 5012 (October 9, 1969).
80. *See* S.E.C. Reg. § 231.4552, 27 Fed. Reg. 11316 (1962).
81. WHEAT REPORT, chap. VII, at 272 et seq.
82. *Id.*
83. 15 U.S.C. § 77e(a) (1964).
84. S.E.C. Securities Act Release No. 5012 (October 9, 1969). The text of the proposed Rule 133 is as follows:
(a) Where there is submitted to the vote or consent of the stockholders of a corporation

is not in itself an offer to sell under section 5 of the Securities Act.[85] However, this would require the revision of Form S-14 which is a short form provided by the S.E.C. for the registration of securities offered by persons deemed to be underwriters under the present Rule 133;[86] in the past Form S-14 basically consisted of a

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(1) a proposal for the reclassification of its securities which involves the substitution of a new security or securities for an existing security;

(2) a plan or agreement for a statutory merger or consolidation under which such a corporation will not survive; or

(3) a plan or agreement for the transfer of assets of such corporation to another person in consideration of the issuance of securities of such other person or any of its affiliates

then such corporation (in the event of a reclassification of its securities), or the person or corporation whose securities are to be issued in connection with such merger or consolidation or transfer of assets, shall be deemed to have offered such securities for sale to such stockholders, provided that, in the event of a transfer of assets, the plan or agreement provides for dissolution of the corporation whose stockholders are voting, or the board of directors of such corporation adopts resolutions relative to its dissolution, within one year after the taking of such vote of stockholders.

(b) This rule shall supersede the provisions of Rule 133, as previously in effect, on and after . . . , and shall have no effect upon proposals, plans or agreements submitted to the vote or consent of the stockholders of any corporation prior to that date.

(c) (1) For the purpose only of § 2(10) and 5 of the Act, a notice of meeting of stockholders for the purpose of voting on or consenting to a proposal or plan for reclassification, merger or transfer of assets referred to in paragraph (a) shall not be deemed to offer a security for sale, provided all of the following conditions are met:

(A) Such notice contains only a brief description of the matters to be voted upon and any other matters required by State law;

(B) A prospectus meeting the requirements of § 10(a) of the Act relating to such proposal or plan is sent or given to each security holder who is entitled to vote upon the proposal or plan at least 20 days prior to the meeting date, provided, that in the case of a class of securities in unregistered or bearer form, such prospectus need be transmitted only to those security holders whose names and addresses are known to the issuer and to those whose proxies or consents are otherwise solicited; and

(C) No other offer is made to security holders and no other solicitation is made on behalf of the proposal or plan prior to the transmission of the prospectus referred to in Clause (B), except as provided in subparagraph (2) below.

(2) For the purpose only of § 2(10) and 5 of the Act, a communication subject to and meeting the requirements of Rule 14a-12(a) under the Securities Exchange Act of 1934 and filed in accordance with paragraph (b) of said rule shall not be deemed to offer a security for sale.

Note:

A. A reclassification of securities covered by this rule would be exempt from registration pursuant to § 3(a)(9) or 3(a)(10) of the Act if the conditions of either of these sections are satisfied.

B. Transactions by issuers of securities described in this rule are exempt from registration requirements under § 4(2) if they are transactions "not involving any public offering." See Rule 180 as to the effect of resales of securities by persons other than the issuer thereof not constituting "distributions" under Rule 162 upon the applicability of that exemption. See also Rule 181 for definition, in connection with the acquisition of a bona fide going business, of the phrase "not involving any public offering" in § 4(2).

85. *Id.*

86. *Id.*

proxy statement meeting the requirements of the S.E.C.'s proxy rules under the Securities Exchange Act of 1934.[87] Since under the proposed Rule 133 a full-fledged registration statement will be required if more than 25 shareholders are involved, the proposed revision of Form S-14 would allow for alternative filings, either a proxy statement or an information statement, meeting the requirements of the S.E.C.'s rules.

The filing of the registration statement in Form S-14 would take the place of the filing of a proxy statement and form of proxy, or information statement, pursuant to the proxy or information rules, and the transmittal of such material to stockholders would comply with the requirements of the Act for the furnishing of a prospectus.[88]

A new Rule 153A would be promulgated to define the term "preceded by a prospectus," in connection with transactions to which Rule 133 applies as meaning

> the sending of a prospectus prior to the vote of security holders on the transaction to all security holders of record entitled to vote thereon at their addresses of record on the transfer records of the corporation whose security holders are voting.[89]

Other changes necessitated by the proposed revision of Rule 133 would include revising paragraph (d) of Rule 14a-2 which presently provides that the proxy rules shall not apply to any solicitation involved in the offer or sale of securities registered under the Securities Act of 1933.[90] It will be necessary to amend this pro-

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87. The proxy rules of the S.E.C. are set forth in The Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78n (1964).

88. 15 U.S.C. § 78n (1964).

89. Rule 153A, as suggested in S.E.C. Securities Act Release No. 5012 (October 9, 1969) states:

> The term "preceded by a prospectus," as used in § 5(b)(2) of the Act in respect of any requirement of delivery of a prospectus to security holders of a corporation, where there is submitted to the vote of such security holders a plan or agreement for a statutory merger, consolidation or reclassification of securities or a proposal for the transfer of assets of such corporation to another person, shall mean sending of a prospectus, prior to such vote, to all security holders of record of such corporation entitled to vote on such plan, agreement or proposal, at their addresses of record on the transfer records of such corporation.

90. S.E.C. Securities Act Release No. 5012 (October 9, 1969). Proposed Rule 14a-2(d) provides:

> (d) Any solicitation involved in the offer or sale of securities registered under the Securities Act of 1933; Provided, That this paragraph shall not apply to securities to be issued in any transaction referred to in Rule 133 under that Act.
>
> Note. Attention is called to General Instruction D to Form S-14. Solicitation material filed as a part of a registration statement on that form need not be filed pursuant to Rule 14a-6. How-

vision so that the exemption will not apply to solicitations involved in the offer or sale of registered securities to be issued in a Rule 133 type transaction. Thus, in such situations both the proxy rules and the registration requirements will apply.[91] However, material filed with the registration statement will not need to be filed under the proxy rules.[92]

The S.E.C. would also promulgate a new Rule 196 which would define certain terms used in the definition of "underwriter" in section 2(11) of the Act so that certain persons, *e.g.*, a corporation, its officers or directors, involved in business combinations would not be deemed to be underwriters.[93]

Proposed Rule 181

An important corollary to the proposed Rule 133 is the proposed new Rule 181[94] which would interpret section 4(2) of the Securities Act which sets forth the "private offering" exemption.[95] A sale of securities is exempt from the registration requirement of section 5 of the Securities Act if it is a "transaction by an issuer

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ever if any soliciting material is used which is not filed as a part of the registration statement, such material shall be filed in accordance with the requirements of these rules.

91. S.E.C. Securities Act Release No. 5012 (October 9, 1969).

92. *Id.*

93. S.E.C. Securities Act Release No. 5012 (October 9, 1969).

94. Rule 181, as suggested in S.E.C. Securities Act Release No. 5012 (October 9, 1969) states:

(a) A transaction by an issuer shall be deemed a transaction "not involving any public offering," as that phrase is used in § 4(2) of the Act, if it consists of an offer and sale of securities, made solely in connection with the acquisition of a business by the issuer, to not more than 25 offerees who are holders of interests in such business, whether the acquisition takes the form of a voluntary exchange of securities, a statutory merger or consolidation, or a purchase of assets of such business, unless a reoffering of such securities by one or more of such original offerees shall cause the entire transaction to involve a public offering.

(b) For purposes of this rule, an "offeree" shall include (1) an individual, (2) his spouse and minor children, (3) any trust or estate in which such individual, his spouse, and any of his or his spouse's minor children, collectively have a substantial beneficial interest or as to which any of the foregoing serves as trustees, executor, or in a similar fiduciary capacity, (4) any partnership substantially all of the partnership interests in which are held by such individual, his spouse and minor childen of such individual or of his spouse, and (5) any corporation or other organization substantially all of the shares of which are held beneficially by such individual, his spouse and minor children of such individual or of his spouse.

Note: This rule is not intended to be exclusive. Depending upon the circumstances of the individual case, a transaction by an issuer of the type referred to in the rule in which securities are offered or sold to more than 25 persons may be a transaction "not involving any public offering." Issuers of securities should be aware of the fact that they bear the burden of proving that the exemption provided by § 4(2) applies to any such transaction. Persons who acquire securities in a transaction not involving a public offering should bear in mind that they may be deemed underwriters upon the resale of the securities in a transaction or transactions involving a distribution.

95. 15 U.S.C. § 77(d)(2) (1964).

not involving any public offering."[96] Rule 181 would define a non-public offering as including an

> offer or sale of securities to not more than twenty-five persons who are holders of interests in such business, whether the acquisition takes the form of a voluntary exchange, a statutory merger or consolidation or a transfer of assets.[97]

However, it should be noted that a public offering within section 4(2) of the Securities Act would exist if one or more of such persons should make an immediate reoffering of the securities to the public, and under such circumstances *any* shareholder of a constituent corporation (*e.g.*, John Smith) would be subject to registration requirements for the resale. Any broker or dealer in securities who might subsequently purchase from the controlling shareholder "would be required to satisfy himself that the initial purchaser had not purchased [received merger stock] with a view to distribution."[98] However, the longer the controlling shareholder retains the stock acquired through the merger, the more persuasive would be the argument that the resale is not at variance with "an original investment intent" rather than with "a view to distribution."[99] But the length of time between acquisition and resale is merely one evidentiary fact to be considered.[100] Thus, if John Smith or the Roes attempted to resell their stock within a short time period after the merger, they would be subject to proving the very subjective fact that they originally took said stock with an "investment intent."[101]

The new Rule would further provide that in computing the 25 persons limitation, certain family members and family interests are to be regarded as a single person for the purposes of the Rule.[102]

Conclusion

The controversy surrounding Rule 133 in the past has involved factual situations very similar to the hypothetical used in this Comment. Under the existing Rule 133, controlling shareholders of the constituent corporation are subject to the one per cent (1%) -

96. *Id.*
97. *See* note 94 and accompanying text *supra.*
98. S.E.C. Release No. 33-285, 11 Fed. Reg. 10952 (1935).
99. S.E.C. Release No. 4552, 27 Fed. Reg. 11316 (1962).
100. *Id.*
101. *See* Ambrosia Minerals, Inc., 39 S.E.C. 734 (1960). The problem concerning investment interest has been associated with the "change of circumstances doctrine." What constitutes change of circumstances is extremely subjective. For a thorough analysis *see* Wheat Report, chap. VI, at 166 et seq.
102. S.E.C. Securities Act Release No. 5012 (October 9, 1969).

six month limitation[103] which may extend their sale of the issuer's shares over numerous years (*e.g.* in John Smith's case, probably at least 2½ years). Furthermore, the present Rule emphasizes form over substance with its present merger, consolidation-voluntary exchange distinction.[104]

> Assuming that Corporation B's outstanding shares are held by 400 shareholders of record (so that the requirement of registration under § 12 of the '34 Act is inapplicable) then, if Corporation A wishes to offer its shares in a voluntary exchange for the outstanding shares of B, it must register the shares to be offered under the '33 Act and deliver a prospectus to the offerees. If the transaction can be structured as a merger or sale of assets and Rule 133 applies, however, not only is registration under the '33 Act avoided but, under the laws of many states, the only document which must be sent the shareholders of B in advance of their vote on the transaction is a bare notice of meeting.[105]

Are these distinctions justifiable? Do they not necessarily emphasize form over substance? The solution offered by the S.E.C. seems to be a halfway measure. It covers the situation where the merging, constituent corporation has a relatively large number of shareholders (*i.e.* more than 25). It has not, however, reached the very prevalent situation, as outlined by the hypothetical in this Comment, in which a close family corporation merges with a large public corporation. Very often the reason for such a merger is that the principle shareholders of the close corporation wish to relieve themselves of the management responsibilities which they have successfully fulfilled in building the size and reputation of their concern. Their purpose for merging often includes the wish to provide liquid assets to benefit them in their retirement and to provide for a reasonably liquid estate.

When the shares in the new corporation which they received through the merger are not registered, which is possible under the presently existing Rule 133 and under the proposed Rule 133 in situations where there are less than 25 shareholders, such principals of the merged corporation find themselves severely limited in the sale of their newly acquired stock, even if they attempt to use the "private offering" exemption of section 4(2) of the Securities Act. Of course, the terms of the merger could provide that their shares be registered, but the inclusion of such a provision would certainly depend on the constituent corporation's bargaining position. Registration requires time and expense with which the public corporation would most likely wish to dispense. It is submitted that the proposed Rule 133's built-in protection for shareholders of a large constituent corporation, *i.e.* the requirement of registration if there are more than 25 shareholders in a constituent cor-

103. *See* notes 9 and 52 and accompanying text *supra.*
104. *See* notes 10-18 and accompanying text *supra.*
105. WHEAT REPORT, chap. VII, at 271 et seq.

poration, is equally important, if not more so, in the situation of a merged close corporation with less than 25 shareholders possibly lacking the bargaining power to *require* registration as part of the merger agreement. The proposed Rule 133 should be carried one step further than is presently in the contemplation of the Securities and Exchange Commission and provide for full disclosure and registration by the issuer in all merger transactions.

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