

11-1-1976

Defining Control in Secondary Distributions

Rutheford B. Campbell Jr

Follow this and additional works at: <http://lawdigitalcommons.bc.edu/bclr>

 Part of the [Securities Law Commons](#)

Recommended Citation

Rutheford B. Campbell Jr, *Defining Control in Secondary Distributions*, 18 B.C.L. Rev. 37 (1976),
<http://lawdigitalcommons.bc.edu/bclr/vol18/iss1/2>

This Article is brought to you for free and open access by the Law Journals at Digital Commons @ Boston College Law School. It has been accepted for inclusion in Boston College Law Review by an authorized administrator of Digital Commons @ Boston College Law School. For more information, please contact nick.szydowski@bc.edu.

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

RUTHEFORD B. CAMPBELL, JR.*

Section 2(11) of the Securities Act of 1933 (Act)¹ generally subjects the sale of securities by a person "controlling an issuer" to the same rules that govern the sale of securities by an issuer.² Accordingly, before a "control" person may sell the securities he holds in the controlled corporation he must either register them with the Securities and Exchange Commission (Commission)³ or qualify for an exemption from the registration requirement.⁴ While the Act clearly requires that a "control" person either register or qualify for an exemption, it fails to define "control." Thus, the task of defining has fallen to the Commission and to the courts. To date, as evidenced by the apparent development of two definitions of control rather than one, their definitional attempts have largely failed to provide a selling shareholder with clear guidelines as to when he will be considered a control person.

This article will initially discuss the two existing general definitions of control and suggest that only one of these definitions provides both an understandable and workable norm. Factors which the courts and the Commission have utilized in reaching a decision that a selling shareholder is a control person will then be isolated and examined in terms of their utility as general indices of control under each of the two definitions. Finally, two techniques to remedy the present lack of certainty will be suggested.⁵

*Associate Professor of Law, University of Kentucky; B.A. 1966, Centre College; J.D. 1969, University of Kentucky; L.L.M. 1971, Harvard University.

¹ 15 U.S.C. § 77(b)(11) (1970).

² Section 2(11) must be read in conjunction with §§ 4(1) and 5 of the Act. Section 5 makes offers and sales of securities illegal if the securities have not been registered by the issuer with the Securities and Exchange Commission or if the offer or sale is not accompanied or preceded by a prospectus. 15 U.S.C. § 77(e)(1970). Section 4(1) states that the provisions of § 5 shall apply only to issuers, underwriters and dealers. 15 U.S.C. § 77(d)(1) (1970). Section 2(11), in pertinent part, defines an underwriter as "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 . . ." The section further provides: "As used in this paragraph the term 'issuer' shall include . . . any person directly or indirectly controlling . . . the issuer." 15 U.S.C. § 77(b)(11) (1970). The cumulative effect of these sections is to require a control person who sells his securities through an underwriter to comply with the requirements of § 5.

³ 15 U.S.C. § 77(e) (1970).

⁴ See, e.g., 15 U.S.C. § 77(d)(1)(1970) and Rule 144, 17 C.F.R. § 230.144 (1976), promulgated thereunder. It is relevant to note that there are some differences between the exemptions available to an issuer and the exemptions available to a control person. For example, a control person is not permitted to use Rule 146, 17 C.F.R. § 230.146 (1976), in the sale of his securities. *Id.* at Preliminary Note 6.

⁵ Securities sales by control persons are commonly referred to as "secondary distributions." 1 L. LOSS, SECURITIES REGULATION 183 (1961). This term will be used

I. CONTROL: TWO GENERAL DEFINITIONS

It appears that two definitions of control have been developed by the courts and the Commission. The first of these defines control in terms of the seller's ability to obtain registration.⁶ Under this test, an individual is considered to be a control person if he or she can cause the corporation to gather the information and to secure the appropriate signatures required in a registration statement.⁷ The second definition, which focuses on the seller's power to direct the management and policies of the corporation, has been expressly formulated by the Commission in Rule 405 as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."⁸ Thus, whereas some courts apparently place a premium on the seller's ability to obtain registration,⁹ the Commission¹⁰ and other courts¹¹ seemingly place a premium on the seller's power to direct the corporation's management and policies.¹²

While the two definitions of control—the ability to procure registration and the power to direct management and policies—appear to be different, they would be conceptually identical if the "power to direct management" were defined as the ability to procure registration. Significantly, it can be inferred from some of the cases in which the two tests have been considered together that courts have actually equated the two definitions. For example, in *S.E.C. v. Micro-Moisture Controls, Inc.*¹³ the court found certain persons "in control because they possessed and exercised the power to direct the management and policies of Micro-Moisture (Rule 405) and particularly were in a position to obtain the required signature of Micro-Moisture and its officers and directors on a registration statement."¹⁴ Similarly, in *S.E.C. v.*

throughout this article to refer to such sales.

⁶ See, e.g., *SEC v. International Chem. Dev. Corp.*, 469 F.2d 20, 28, 30-31 (10th Cir. 1972); *Pennaluna & Co. v. SEC*, 410 F.2d 861, 865, 866 (9th Cir. 1969); *SEC v. American Beryllium & Oil Corp.*, 303 F. Supp. 912, 915 (S.D.N.Y. 1969); *SEC v. North Am. Research & Dev. Corp.*, 280 F. Supp. 106, 121 (S.D.N.Y. 1968); *SEC v. Micro-Moisture Controls, Inc.*, 148 F. Supp. 558, 562 (S.D.N.Y. 1957); 2 L. Loss, *SECURITIES REGULATION 780-81* (1961); E. McCORMICK, *UNDERSTANDING THE SECURITIES ACT AND THE SEC 69* (1948).

⁷ Professor Loss has characterized this as the "pragmatic" test generally applied by the Commission. 1 L. Loss, *SECURITIES REGULATION 557* (1961). This test also has been characterized as the test "most universally accepted." 9 ALR Fed. 639, 645 (1971). In other instances, it has been described as a "significant test." *SEC v. International Chem. Dev. Corp.*, 469 F.2d 20, 28 (10th Cir. 1972).

⁸ 17 C.F.R. § 230.405(f) (1976).

⁹ See note 6 *supra*.

¹⁰ See, e.g., *In re Thompson Ross Sec. Co.*, 6 S.E.C. 1111, 1119 (1940).

¹¹ See, e.g., *SEC v. American Beryllium & Oil Corp.*, 303 F. Supp. 912, 915 (S.D.N.Y. 1969); *SEC v. Computronic Indus. Corp.*, 294 F. Supp. 1136, 1139 (N.D. Tex. 1968); *SEC v. Franklin Atlas Corp.*, 154 F. Supp. 395, 400 (S.D.N.Y. 1957).

¹² Some commentators also have advocated this approach. See e.g., Sommer, *Who's In Control?*—*S.E.C.*, 21 BUS. LAW. 559, 582 (1966) [hereinafter cited as Sommer].

¹³ 148 F. Supp. 558 (S.D.N.Y. 1957).

¹⁴ *Id.* at 562.

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS.

*International Chemical Development Corp.*¹⁵ the court treated an individual as a control person not only because his "active participation in the management of the [company]" was clearly shown, but also because "his ability to compel registration" was demonstrated.¹⁶ On the other hand, at least one court appears not to have equated the two definitions. In *S.E.C. v. North American Research & Development Corp.*¹⁷ the court, without discussion of the two definitions, appears to have utilized the ability to obtain registration norm in finding that the corporation's majority shareholder was a control person and the power to direct management standard in finding that the majority shareholder's "business adviser" was a control person.¹⁸

In light of the apparent confusion in the courts as to the appropriate test of control, it is submitted that the relevant consideration and appropriate definition of control should be the shareholder's ability to obtain registration. At least two reasons support this approach. First, this definitional focus is seemingly more consistent with the congressional intent underlying the imposition of the registration requirement on control persons. Control persons appear to be subject to the Act's registration requirement not only because of the dangers associated with a large distribution of securities, but also because control persons are in a position to demand registration of the securities to be offered.¹⁹ The most fundamental danger accompanying a large distribution of securities is the possibility that many purchasers will buy securities without access to information about the issuer on which they can base an informed investment decision.²⁰ To the extent, however, that the seller is in a control relationship with the original issuer, it is reasonable to assume that he can either force or persuade the issuer to register the security and thereby insure that prospective purchasers will have sufficient access to information on which to base their investment decisions. Indeed, the legislative history of the Act's control provision, albeit somewhat meager, supports this assumption.²¹ The House of Representative's Committee Report specifically states that an offering by a control person

may possess all the dangers attendant upon a new offering of securities. Wherever such a redistribution reaches sig-

¹⁵ 469 F.2d 20 (10th Cir. 1972).

¹⁶ *Id.* at 30.

¹⁷ 280 F. Supp. 106 (S.D.N.Y. 1968).

¹⁸ *Id.* at 121.

¹⁹ S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 21 (C. Israels, ed. 1962) [hereinafter cited as Israels]; Note, *The Meaning of "Control" in the Protection of Investors*, 60 YALE L.J. 311, 321 (1951).

²⁰ The purpose of the 1933 Act was to force disclosure necessary to remedy the informational void. See 1 L. LOSS, SECURITIES REGULATION 1-22, 107-28 (1961) for a discussion of how this and other dangers precipitated the 1933 Act. For a brief discussion of the purpose and mechanics of the 1933 Act, see *In The Matter of Ira Haupt & Co.*, 23 S.E.C. 589, 595 (1946).

²¹ See H.R. REP. NO. 85, 73d Cong., 1st Sess. 13-14 (1933).

nificant proportions, the distributor would be in the position of controlling the issuer and thus able to furnish the information demanded by the bill. This being so, the distributor is treated as equivalent to the original issuer and, if he seeks to dispose of the issue through a public offering, he becomes subject to the act.²²

In light of the Committee Report, it seems apparent that Congress was willing to saddle a control person with the responsibility of registering his securities because he could furnish the information required by the registration statement. By contrast, it is not clear that one who has the power to direct the management and policies of a corporation necessarily possesses the power to obtain registration. For example, the owners of a corporation may hire a general manager to run the corporation's day to day operations. Although the manager may have the power to direct management, he may remain powerless to obtain registration, since his office does not give him the power to demand that the company register. It would seem both unfair and inconsistent with the philosophy of section 2(11) to treat the hapless general manager as a control person. Under the power to direct management norm he would likely be treated as such. If, however, the ability to obtain registration standard were utilized, he would not be treated as a control person. Thus, the registration approach is more precisely tailored to meet Congress' expressed intent than is the power to direct management approach.

In addition to attaining philosophical consistency with the apparent congressional intent underlying the imposition of the registration requirement on control persons, selection of the ability to obtain registration approach provides an understandable, albeit general, norm. A selling shareholder usually can determine whether he reasonably can force or persuade the corporation to gather the information required in the registration statement and reasonably can obtain the necessary signatures. In contrast, defining control as the power to direct management leaves a fundamental question unanswered: what quantity and quality of management function must one have in order to be deemed in control? Under the power to direct management standard, a selling shareholder who directs a retail corporation's sales promotions may wish to sell his small, less than one percent, block of stock in the corporation. Assuming that this management function is his only connection with the corporation, other than his small amount of stock, his control status would depend on whether the power he wields in directing sales promotions sufficiently constitutes power to direct management and policies. Although one may have some intuitive feeling about his status, because Rule 405 fails to define what type of power is sufficient to support a finding of control, it provides no basis for objectively determining if he is a con-

²² *Id.*

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

control person. Moreover, the Commission has not sought to elucidate the Rule. Under the ability to obtain registration norm, however, the status of the director of sales promotions is less uncertain, although he appears not to be a control person because he is in a position neither to demand nor to persuade the corporation to register.

Thus, two reasons support selection of the ability to obtain registration norm and rejection of the power to direct management standard. First, the registration norm is more consistent with the policy underlying the Act. Second, it is fairer to the selling shareholder since it provides him with a more intelligible norm for determining whether or not he is a control person and hence, whether or not he is subject to the Act's registration requirement.

Although the ability to obtain registration definition is the more workable norm, it has not been unanimously accepted.²³ Accordingly, a selling shareholder must presently examine other factors in order to determine whether he or she is a control person. These factors fall into three general categories: ownership interest, management position and personal or business relationship. This article will isolate these factors by examining decisions which the courts and the Commission have reached in determining whether an individual is a control person within the meaning of section 2(11).²⁴

II. INDIVIDUAL CONTROL

A. *Bases for Individual Control*

1. Ownership Interest in the Corporation

Perhaps the most obvious factor providing a basis for individual control is an ownership interest in the particular company, since an ownership interest typically gives the shareholder power both to vote for directors and to vote on some important corporate decisions.²⁵ It is well settled that unless there has been some delegation of voting power, an individual who has 51 percent of the voting stock of a company is a control person because he has the power to elect a majority of the board of directors,²⁶ and hence, the power to either obtain registration or direct the management and policies of the company. It is clear, however, that a shareholder with less than 51 percent of the voting stock of a corporation can be a control person for the

²³ See text at notes 9-12 *supra*.

²⁴ A detailed discussion of each category begins with the text at note 25 *infra*.

²⁵ One commentator has observed that "[t]he initial source of power of necessity must be ownership of voting securities. . . . The Power of management is *ultimately* . . . in the hands of the holders of voting securities." Sommer, *supra* note 12, at 566-67.

²⁶ *Id.* at 567. In *SEC v. North Am. Research & Dev. Corp.*, 280 F. Supp. 106 (S.D.N.Y. 1968), the court found that South Utah Mines was in control of North American because "it owned more than 50% of the outstanding shares of North American . . ." *Id.* at 121.

purposes of section 2(11). In *In re Thompson Ross Securities Co.*,²⁷ for example, the Commission stated that "[c]ontrol" is not synonymous with the ownership of 51 percent of the voting stock of a corporation.²⁸ Yet, it is impossible to declare with certainty that any particular percentage less than 51 percent will be sufficient for control. Historically, the courts and the Commission have found control to exist where the percentages of ownership have been substantially below 51 percent.²⁹ For example, in *United States v. Wolfson*³⁰ and *S.E.C. v. Micro-Moisture Controls, Inc.*³¹ persons or groups with 40 to 50 percent ownership were treated as control persons.³² Yet, in the *Thompson Ross* proceedings, the Commission treated an individual who owned 18 percent as a control person.³³ Finally, in *United States v. Sherwood*,³⁴ the court refused to find control where the selling

²⁷ 6 S.E.C. 1111 (1940).

²⁸ *Id.* at 1119.

²⁹ In *U.S. v. Wolfson*, 405 F.2d 779 (2d Cir. 1968), and *SEC v. Micro-Moisture Controls, Inc.*, 167 F. Supp. 716 (S.D.N.Y. 1958), *aff'd sub nom.*, *SEC v. Culpepper*, 270 F.2d 241 (2d Cir. 1959), the persons or groups with stock ownership of 40 to 50% were found to be control persons. *Wolfson* at 781; *Micro-Moisture* at 738. In *In re Thompson Ross Securities Co.*, 6 S.E.C. 1111 (1940), the Commission found control under § 2(11) where the particular individual owned 18% of the voting stock. *Id.* at 1120. However, there were a number of other factors that were important to the determination that Allen had control of the company. The Commission stated:

"Allen is president of the issuer and its largest stockholder He was in complete charge of its affairs; for years he had managed the issuer and formulated its policies Allen held proxies for over 50% of the outstanding shares."

Id. at 1120-21.

In *U.S. v. Sherwood*, 175 F. Supp. 480 (S.D.N.Y. 1959), the court refused to find control where there was only 8% ownership. *Id.* at 483. Factors other than stock ownership were also emphasized by the court, which stated that Sherwood

was unable to secure representation on the board of directors, he had had a falling-out with John Christopher Doyle, who appears to have been the dominant figure in the management of Canadian Javelin Limited, and Sherwood was unable to free the bulk of his shares for distribution until Doyle consented thereto.

Id. In *Wellington Tech. Indus., Inc.*, [1970-71 Transfer Binder] CCH FED. SEC. L. REP., ¶ 78,039, at 80,269 (SEC 1971), the Commission, in a no-action letter, permitted an unregistered sale of securities where the seller owned 6.7%. *Id.* Similar no-action responses can be found in instances where the seller owned 5.4%, *Amerada Hess Corp.*, [1970-71 Transfer Binder] CCH FED. SEC. L. REP., ¶ 78,083, at 80,349 (SEC 1971), and 3.2%, *Weil-McLain Co.*, [1970-71 Transfer Binder] CCH FED. SEC. L. REP., ¶ 78,038, at 80,266-67 (SEC 1971). No-action letters are responses by the Commission's staff "to private inquiries as to whether a certain transaction could be carried out in a specified manner. These responses are known as 'no-action' letters because they customarily state that the staff will recommend no action to the Commission if the transaction is done in the specified manner." D. RATNER, SECURITIES REGULATION 18 (1975).

³⁰ 405 F.2d 779 (2d Cir. 1968).

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

³² *Wolfson* at 781; *Micro-Moisture* at 738.

³³ 6 S.E.C. at 1120.

³⁴ 175 F. Supp. 480 (S.D.N.Y. 1959).

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

shareholder owned only 8 percent of the voting stock.³⁵ Thus, although it is impossible to declare that any particular percentage less than 51 percent will be sufficient for a finding of control, it can be inferred from these examples and other decisions that when an individual owns 10 percent or more of the voting stock of a company, he may be treated as a control person. This inference is also consistent with the writings in this area which generally have suggested that ownership of 10 percent of the voting stock of a company should be considered a "red light" signaling that there is a danger of control status.³⁶

Still, one cannot accurately determine whether control is present by merely quantifying stock ownership. The distribution of the corporation's voting securities also has an impact on control. Former SEC Commissioner Sommer observed that as voting stock becomes more widely dispersed, the amount necessary to control becomes smaller.³⁷ Conversely, as the voting securities become concentrated in fewer shareholders, the percentage of stock that any one shareholder would need to be a control person increases. Thus, a person with 25 percent of a widely-held company would be more likely to be a control person than would a 25 percent owner of a company with only 5 shareholders.

Another important factor that may affect control is the type of security owned by the shareholder. If the security gives the individual the power to either obtain registration or direct the management and policies of the corporation he may be treated as a control person. Thus, if convertible debentures, nonconvertible debentures, or non-voting preferred stock confers such power on the holder, he may be a control person since power is a key ingredient of control. Whichever definition of control one adopts, power is important, since it can provide a means to demand registration or to direct the management of the corporation. To the extent, therefore, that ownership of any security, whether debt or equity, preferred or common, voting or non-voting, generates power, that ownership is relevant to the issue of control.

The power accompanying different types of securities depends on the contractual terms of the security as well as the existing corporate realities. Quite clearly, one owning 51 percent of the common stock of a corporation has more power than does one who owns 51 percent of the non-voting preferred stock since the contractual voting rights of the common shareholder give him control over the board of directors. Similarly, corporate realities may become important

³⁵ *Id.* at 483.

³⁶ *See*, Enstam & Kamen, *Control and the Institutional Investor*, 23 BUS. LAW. 289, 315 (1968) [hereinafter cited as Enstam & Kamen, Sommer, *supra* note 12, at 568. It even has been suggested by one commentator that 5% is the relevant figure. Israels, *supra* note 19, at 19.

³⁷ Sommer, *supra* note 12, at 569.

in the case of convertible debentures; as the conversion ratio becomes more attractive, the power of the convertible debenture owner increases. When conversion becomes a real possibility, it gives the owner of the convertible debentures increased power. Thus, there might well be instances in which holders of non-voting securities could be found to have sufficient power to warrant a finding that they are control persons.³⁸

Thus, it is apparent that an ownership interest in a corporation is a factor that is relevant to the determination of control, irrespective of the definition of control adopted. There are indications that ownership of 10 percent or more of a corporation subjects the shareholder to some risk of being a control person. One must, however, treat that as a crude rule of thumb, since other factors are relevant to the ultimate determination of control. These other factors include distribution of ownership and the type of contractual rights enjoyed by the particular shareholder.

2. Officer or Director

A seller's management position with a corporation often is emphasized as an important factor in determining control.³⁹ Although in determining whether an individual is a control person the courts typically emphasize positions such as an officer, director or member of an executive committee,⁴⁰ an untitled, *de facto* management position is also important.⁴¹ While it generally is agreed that occupying a significant management position is a factor of control, the weight to be accorded to one's position as an officer or director is less than clear. Professor Loss has stated that "although a person's being an officer or director does not create any *presumption* of control, it is a sort of red light."⁴² On the other hand, there is some case authority which sup-

³⁸ See Enstam & Kamen, *supra* note 36, at 316-17.

³⁹ Former Commissioner Sommer has discussed the problem in terms of whether being an officer or director will "automatically constitute one a member of the controlling group." Sommer, *supra* note 12, at 576-77. See also cases cited at note 43 *infra*. As will be suggested *infra*, this consideration unnecessarily confuses the analysis. See text at note 51 *infra*.

⁴⁰ See, e.g., SEC v. International Chem. Dev. Corp., 469 F.2d 20, 31 (10th Cir. 1972); SEC v. National Bankers Life Ins. Co., 334 F. Supp. 444, 449, 450, 452 (N.D. Tex. 1971); SEC v. North Am. Research & Dev. Corp., 280 F. Supp. 106, 121 (S.D.N.Y. 1968); U.S. v. Sherwood, 175 F. Supp. 480, 483 (S.D.N.Y. 1959); *In re* Thompson Ross Sec. Co., 6 S.E.C. 1111, 1119 (1940).

⁴¹ In U.S. v. Wolfson, 405 F.2d 779 (2d Cir. 1968), the court, in deciding to subject Wolfson to the constraints of § 2(1), found that although Wolfson was not an officer or director he was the corporation's "guiding spirit." *Id.* at 781. In SEC v. Franklin Atlas Corp., 154 F. Supp. 395 (S.D.N.Y. 1957), the court found that an individual (John L. de Lyra) who was not an officer or director was a control person, due at least in substantial part, to the fact that through his sister he exercised *de facto* control over the management of the corporation. *Id.* at 400-401. In addition to personal relationships, business relationships can also be a basis for finding *de facto* control. See text at notes 56-57 *infra*.

⁴² 2 L. LOSS, SECURITIES REGULATION 781 (1961).

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

ports the notion that one who is an officer or director is by definition a control person.⁴³ Indeed, one court stated that "the Commission defined 'control' and all of its derivations to include at the very least any officer or director of the issuer."⁴⁴ Such a finding, however, is against the weight of authority, which indicates that an individual's position is an important but not a determinative factor in ascertaining whether one is a control person.⁴⁵

In evaluating the significance of a seller's position as an officer or director of a corporation, the selection of the appropriate definition of control becomes crucial. If control is defined as the ability to direct the management of the corporation, a seller's status as an officer or director has obvious significance. Since directors and officers usually have at least some power to direct the management and policies of a corporation, arguably, virtually every director and major officer is a control person within the meaning of section 2(11). Such a result, however, is inconsistent with the better view that a position as an officer or director is an important but not a determinative factor.⁴⁶ It also is inconsistent with the legislative purpose underlying the special constraints imposed on control persons by section 2(11),⁴⁷ which indicates that the constraints should be imposed only where the selling shareholder can secure registration.⁴⁸ One's office or directorship alone does not generate such power.⁴⁹

If, on the other hand, control is defined as the ability to procure registration, an individual's status as an officer or director may be less significant. Since registration requires the signature of a majority of the board of directors, as well as certain, enumerated officers,⁵⁰ no single officer or director can, through the exercise of the power of his office, force registration. The voting stock owned by the officer or director may give him the power to force registration, but his office

⁴³ See, e.g., SEC v. National Bankers Life Ins. Co., 334 F. Supp. 444, 452, 458 (N.D. Tex. 1971); SEC v. Computronic Indus. Corp., 294 F. Supp. 1136, 1139 (N.D. Tex. 1968).

⁴⁴ SEC v. Computronic Indus. Corp., 294 F. Supp. 1136, 1139 (N.D. Tex. 1968). It also appears that some persons in SEC v. National Bankers Life Ins. Co., 334 F. Supp. 444, 452, 458 (N.D. Tex. 1971) were held to be in control because they occupied positions as officers and directors.

⁴⁵ In Wilko v. Swan, 127 F. Supp. 55, 56-58, 60 (S.D.N.Y. 1955), a court upheld a special verdict that Page, who was both a director and stockholder, was not a control person. See also, 2 L. LOSS. SECURITIES REGULATION 781 (1961); Enstam & Kamen, *supra* note 36, at 306 ("Representation on the board has been held to be one factor which will be weighed . . .").

⁴⁶ See, e.g., Wilko v. Swan, 127 F. Supp. 55 (S.D.N.Y. 1955) See also note 45 *supra*.

⁴⁷ See text at notes 19-22 *supra*.

⁴⁸ *Id.*

⁴⁹ See text at notes 50-51 *infra*.

⁵⁰ The instructions to the S-1 Registration Form state: "The registration statement shall be signed by the registrant, its principal executive officer or officers, its principal financial officer, its controller or principal accounting officer and by at least the majority of the board of directors or persons performing similar functions." 2 CCH FED. SEC. L. REP. ¶ 7126, at 6221.

alone does not. This is not to say, however, that one's status as an officer or director is irrelevant to the ability to obtain registration. Obviously, it gives one the power to obtain his own signature and support. Additionally, one's status as an officer or director can generate personal contacts with other officers and directors. These personal contacts alone can cause the director or officer to be in a position to obtain the necessary signatures and cause the company to gather the necessary information.⁵¹ It is important to keep in mind, however, that this ability to obtain registration stems from relationships with other corporate officials and not from the power of the office itself. Thus, if the ability to obtain registration norm is utilized, the assessment of whether an officer or director is in control requires an analysis of his personal and business relationships with the other corporate officials. Such an analysis may show the particular officer or director is a minority director who is despised by a majority of the board and all the major officers. In such an instance, the director should not be deemed a control person.⁵²

3. Relationships

It is quite possible that an individual with little or no voting stock ownership could be a control person due to his relationship with the corporation or with the person or persons who have control of the corporation. This type of control by relationship can occur in several situations. Control, for example, could be based upon a contractual relationship. A loan to a majority shareholder could be a basis for control by contractual relationship if, under the terms of the loan agreement, the lender acquires the right to exercise the power of that majority shareholder.⁵³

It also is conceivable that a lender could extract such extensive covenants from a corporate borrower that the lender would attain control over the borrowing corporation. Typically, however, this is not the case. Since the covenants are usually limited to restrictions on future indebtedness, payment of future dividends, etc.,⁵⁴ the lender generally would be unable to secure registration or to direct the management of the company. Accordingly, the lender would not appear to be a control person, at least in the typical loan situation.

⁵¹ Relationships as a basis for control are discussed in the text at notes 53-67 *infra*.

⁵² *Cf.* Sommer, *supra* note 12, at 576-77.

⁵³ *Id.* at 571. An obvious example of a mechanism used to transfer power in this setting is the delivery of a proxy by the borrower to the lender. The fact that the seller of securities "held proxies of over 50 percent of the outstanding shares" was emphasized as an important factor in determining control status in *In re Thompson Ross Sec. Co.*, 6 S.E.C. 1111, 1121 (1940). Former Commissioner Sommer also has stated that "someone who has an irrevocable proxy or right by contract to exercise such an amount of voting power will be a controlling person even though he may not own beneficially a single share." Sommer, *supra* note 12, at 571.

⁵⁴ See *Enstam & Kamen*, *supra* note 36, at 319-25.

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

Control based on a contractual relationship is not limited to loan situations. A majority shareholder could, for example, relinquish his control by placing his stock in a voting trust. In that instance, it appears that the trustee, and not the majority shareholder, would occupy the control relationship with the corporation.⁵⁵

Non-contractual relationships also can cause an otherwise insignificant shareholder to be treated as a control person. *S.E.C. v. North American Research & Development Corp.*⁵⁶ exemplifies the role that business relationships can play in determining whether an individual is a control person. There, the court relied upon an individual's status as a "business adviser" to the company's majority shareholder as an important basis to support its finding of the existence of control.⁵⁷ Courts also have emphasized family and personal relationships as one of several bases for control. In *S.E.C. v. Antoine Silver Mines, Ltd.*,⁵⁸ the court found that a father was a controlling person of two corporations, stating that his "status as a controlling person is indicated by his son's beneficial ownership of all shares of these companies . . ."⁵⁹ Similarly, in *S.E.C. v. National Bankers Life Insurance Co.*⁶⁰ the court founded the existence of an individual's control on the fact that his son-in-law owned a controlling stock interest in the company.⁶¹ Additionally, the absence of a personal relationship has been an important factor in a court's decision to find individual control. In *United States v. Sherwood*,⁶² for example, the court refused to find that the defendant was a control person for several reasons, including the fact that he had suffered a "falling-out" with the individual who appeared to have been the dominant figure in the company's management.⁶³

These examples of non-contractual relationships are not exhaustive.⁶⁴ Yet when considered along with the examples of con-

⁵⁵ In *Micro-Moisture*, 148 F. Supp. at 562, the court stated that an individual (Louis Levin) "stood in the position of a controlling person," apparently due to the fact that he was sole voting trustee of 998,210 shares of the common stock of Micro-Moisture. *Id.* at 562. See also Enstam & Kamen, *supra* note 36, at 318; Sommer, *supra* note 12, at 570.

⁵⁶ 280 F. Supp. 106 (S.D.N.Y. 1968).

⁵⁷ *Id.* at 121. More precisely, Robert Johnson was the business adviser to the parent company's controlling shareholder. *Id.* For further discussion of this case see note 70 *infra*.

⁵⁸ 299 F. Supp. 414 (N.D. Ill. 1968).

⁵⁹ *Id.* at 416 n.1. For further discussion of this case see note 69 *infra*.

⁶⁰ 334 F. Supp. 444 (N.D. Tex. 1971).

⁶¹ *Id.* at 449. It also is relevant to note that the son-in-law's ownership interest in the company had been financed by a bank controlled by his father-in-law. *Id.* at 449. For further discussion of this case see note 69 *infra*.

⁶² 175 F. Supp. 480 (S.D.N.Y. 1959).

⁶³ *Id.* at 483. For further discussion of this case see note 68 *infra*.

⁶⁴ Former Commissioner Sommer has said that a substantial customer could perhaps be a control person where "it has the power to dictate the policies of the corporation." Sommer, *Who's "In Control"?*—*S.E.C.*, 21 BUS. LAW. 559, 573 (1966) [hereinafter cited as Sommer]. In *SEC v. National Bankers Life Ins. Co.*, 334 F. Supp. 444, 452 (N.D. Tex. 1971) the court held that Tom Max Thomas was a controlling shareholder, emphasizing that he was "general counsel" to the company.

tractual relationships, they indicate that certain types of relationships do provide a basis for control. In some instances, relationships can give a shareholder the *raw power* to demand the assistance of another in his attempt to cause the issuer to register. This is illustrated by the examples of contractual relationships. In the more typical situation, however, relationships do not give the selling shareholder the raw power to demand registration. Rather, the relationships provide a shareholder with the means of *persuading* one with power to aid him in his attempt to secure registration. Thus, if an analysis of a selling shareholder's relationship with one who has the raw power to secure registration reveals that it is reasonable to assume that the selling shareholder could persuade that person to aid him in his attempt to obtain registration, the selling shareholder should be treated as a control person. For example, a husband reasonably can be expected to obtain registration if his wife is the majority shareholder of a company. Likewise, a shareholder who is a long-time business associate and friend of a majority shareholder may be in a position to enlist the aid of the majority shareholder. In sum, if control is defined as the ability to obtain registration, relationships are important in determining whether one is in control of a corporation, since the ability to obtain registration can be based on the raw power to command or the ability to persuade.⁶⁵

Under the alternative definition of control — the power to direct management — relationships also can be a basis for control. For example, it may be reasonable to conclude that one family member could persuade another family member to manage a company in a certain way. Likewise, it may be possible for one who lends money to a corporation to extract some power to direct management. This analysis, however, demonstrates the lack of clarity of the power to direct management norm. Under this definitional approach it must be determined whether the relationship is of such strength that a selling shareholder has the power to direct management. Such a judgment usually is impossible because the power to direct management norm does not explicate what functions one must control in order to be within the definition of a control person. Thus, it is unclear, for example, whether a selling shareholder who has a brother who owns 75 percent of the voting stock of the corporation would be found to have the power to direct the management of the corporation if his brother would accede to his request to change the brand of automobiles used by the corporation and also would accede to a request to fire a par-

⁶⁵ One commentator has stated:

[T]he control test is really a device to reach those cases in which the people who are making an offer are in a position, whether it is by persuasion or by a stock control relationship or some other reason, to provide . . . reliable information through the filing of a registration statement by the issuer.

S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 21 (C. Israels, ed.) (statement by Mr. Cohen) [hereinafter cited as Israels].

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

ticular vice-president of the company. If this is the limit of the persuasive power of the selling shareholder, would he have the power to direct management? The problem in answering that question is that the underlying norm—the power to direct management—does not explicate which function the selling shareholder must control in order to be a control person. The ability to obtain registration standard, however, provides a more understandable norm.⁶⁶ Additionally, the ability to obtain registration standard is consistent with the congressional intent underlying imposition of the registration requirement on control persons.⁶⁷

B. *The Red Light District for Individual Control.*

Relatively little difficulty is encountered in recognizing the factors that are relevant to a determination that an individual is a control person, since the cases delineate the factors with reasonable clarity. The difficulty arises, however, in determining whether the factors are present in sufficient quantity and intensity to cause the selling shareholder to be treated as a control person. Although it is most difficult to define in the abstract those situations in which a selling shareholder will be deemed a control person, an analysis of pertinent case law gives rise to a general understanding of how the courts and the Commission have dealt with the control issue.

The cases indicate that if none of the three factors—ownership interest, management position and personal or business relationship—is present, a selling shareholder is unlikely to be declared a control person.⁶⁸ If, however, one of these factors is present, there is a substantial risk that a selling shareholder will be declared a control person.⁶⁹ The presence of two or more factors usually results

⁶⁶ See text following note 22 *supra*.

⁶⁷ See text at notes 19-22 *supra*.

⁶⁸ See *e.g.*, Wellington Technical Indus., Inc. [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,039, at 80,269 (SEC 1971); Amerada Hess Corp., [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,083 at 80,348 (SEC 1971); U.S. v. Sherwood, 175 F. Supp. 480 (S.D.N.Y. 1959). In *Sherwood* the court found that Sherwood was not a control person since he had none of the three bases for control. He owned "8% of the stock of the company, he was unable to secure a representation on the board of directors, [and] he had a falling-out with John Christopher Doyle, who appears to have been the dominant figure in the management" of the company. *Id.* at 483. In *Wellington*, the staff of the commission issued a no-action letter to Enterprise Fund, Inc., which held 6.7% of Wellington's stock. [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,039, at 80,269. No other connection between the two companies was disclosed by the letter or the response. The staff of the Commission also issued a no-action letter in *Amerada Hess*. Amerada Hess owned about 5.4% of the outstanding shares of Louisiana Land and Exploration Co. [1970-71 Transfer Binder] CCH FED. L. REP. ¶ 78,083, at 80,349. No other connection between the two companies was disclosed.

⁶⁹ See, *e.g.*, Pennaluna & Co. v. SEC, 410 F.2d 861 (9th Cir. 1969); SEC v. National Bankers Life Ins. Co., 334 F. Supp. 444 (N.D. Tex. 1971); SEC v. Antoine Silver Mines Ltd., 299 F. Supp. 414 (N.D. Ill. 1968); SEC v. Computronic Indus. Corp., 294 F. Supp. 1136 (N.D. Tex. 1968). In *National Bankers Life* the court held that an indi-

in a determination that a particular individual is a control person.⁷⁰

vidual (Frank W. Sharp) was in control of Olympic Life Insurance Company stating that he "exercised control over OLI through ownership of controlling stock in that company by W.D. Haden, II, Sharp's son-in-law . . ." 334 F. Supp. at 449. Although it was not emphasized by the court, it was noted that the son-in-law's ownership of the stock was financed by a bank in which his father-in-law had the controlling interest. *Id.* Thus, this case can be classified as either a one or two factor case. The court also held that an individual (John Osorio) was in control of National Bankers Life Insurance Company, apparently because of his position as president, director and member of the executive and finance committees. *Id.* at 450. In *Antoine Silver Mines* the court declared an individual (Joseph Kopas) to be a controlling person of Alladin Holdings, Ltd., stating that his control was "indicated by his son's beneficial ownership of all shares of . . . [the] company." 299 F. Supp. at 416 n.1. In *Computronic* the court seemed to find control solely because the selling shareholder was chairman of the board of Computronic. The court stated: "[T]he Commission defined 'control' and all its derivations to include at the very least any officer or director of the issuer." 294 F. Supp. at 1139. In *Pennaluna* the court found that an individual (Magnuson) was a control person on May 8, 1962. 410 F.2d at 866. At that time, he was only a nominal shareholder and was neither an officer nor director. He did, however, have a significant relationship with the group of persons in control of the company. *Id.* at 865-66. Although the court appears to have treated this as a "group" case, declaring the individual to be a member of a control group because of his relationship with its members, *id.* at 866, it is submitted that the court's analysis is conceptually indistinguishable from the determination that an individual has control because of a relationship. See text at notes 53-67 *supra*.

⁷⁰ Cases in which control was an issue can be categorized according to the number of control factors present. It should be noted, however, that some cases do not fit squarely into any particular category.

THREE CONTROL FACTORS:

United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969). Defendant Wolfson was found to be a control person, apparently because he had a significant stock ownership, a relationship with another stockholder (the court said Wolfson, members of his immediate family and a man characterized as his "first lieutenant" owned over 40% of the stock) and a significant management function (the court characterized him as the corporation's "guiding spirit"). *Id.* at 781.

SEC v. International Chem. Dev. Corp., 469 F.2d 20 (10th Cir. 1972). Defendant Richard T. Cardall was considered a control person of International Chemical, apparently because he owned approximately one-sixth of the outstanding stock, was an active participant in the management of the company and had a past business and personal relationship with other substantial shareholders. *Id.* at 30. Another defendant (Joseph A. Holman) also was found to be a control person of International Chemical, apparently because he had a substantial ownership interest (part of which was an ownership in a company that held a substantial share of International Chemical), played an active role in the management of the company and had a business relationship with other shareholders and officers of International Chemical. *Id.* at 31-32.

In re Thompson Ross Sec. Co., 6 S.E.C. 1111 (1940), the Commission declared that the defendant was a control person because he owned 18% of the stock of the company, was its president ("for years he had managed the issuer and formulated its policies"), and had been able to secure proxies for over 50% of the outstanding shares at recent meetings. *Id.* at 1120-21.

TWO CONTROL FACTORS:

SEC v. International Chem. Dev. Corp., 469 F.2d 20 (10th Cir. 1972). The court found an individual (Ray L. Pruett) a control person of International Chemical, apparently because he had performed a significant management function (he had served as

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

Thus, for example, if the selling shareholder has 10 percent of the voting stock of the corporation, performs a significant management function in the corporation, or has a significant relationship with its management or a 10 percent shareholder, there is a *substantial* risk that he will be treated as a control person by a court or the Commission.

While numerous cases support these conclusions,⁷¹ a rational analysis of whether a selling shareholder is a control person cannot be limited to a quantification of the control factors present. The intensity of any one factor is an important additional consideration. For example, if a shareholder's only basis for control is voting securities, the probability of his being a control person increases as his percentage of ownership increases. Thus, if he owns 35 percent, he is more likely to be declared a control person than if he owns only 10 percent.

Because it is impossible to pinpoint what quantity and intensity of factors will cause a court or the Commission to treat a selling

secretary-treasurer and director of the company and had played a generally active role in the running of the company), and had a personal and business relationship with other substantial shareholders (he was part of the original group that purchased large amounts of the stock of the company with the intent to resell that stock to the general public). *Id.* at 30-31. There also were other less significant connections with the company that may have been important. He had owned one or two percent of the company's stock and had some connection with a company that owned a substantial amount of International Chemical stock, although his exact connection with that company is less than clear from the case. *Id.*

SEC v. National Bankers Life Ins. Co., 334 F. Supp. 444 (N. D. Tex. 1971). An individual (Tom Max Thomas) was found to be in a control relationship with South Atlantic company, apparently because he was the secretary of the company and had business dealings with other substantial stockholders (John Osorio and Waggoner Carr) who were associated with him in the practice of law and other business interests. *Id.* at 447, 452. Moreover, the court stated that "those substantial shareholders had "purchased control of South Atlantic Company . . ." *Id.* at 447. It appears that the individual in question had no major stock interest in the company since the court did not refer to it. The same court also found that this individual was in control of Master Control, Inc., apparently, because he was in a management position (he was secretary, general counsel and director), and was a business companion of the individual who was the controlling shareholder of Master Control's parent company. *Id.* at 452, 458.

SEC v. North Am. Research & Dev. Corp., 280 F. Supp. 106 (S.D.N.Y. 1968). An individual (Robert A. Johnson) was found to be a control person of North American, apparently because of his control relationship with North American's parent company, South Utah. He was a director and officer of South Utah and "business advisor" to the person who owned 70% of South Utah. *Id.* at 121.

SEC v. Franklin Atlas Corp., 154 F. Supp. 395 (S.D.N.Y. 1957). The court held that an individual (John L. de Lyra) was in control of Franklin. *Id.* at 401. Although it is not entirely clear, it appears that this individual had a family relationship with major stockholders and was active in the management of the company. *See, id.* at 399-401. His stock ownership is not clear. For more factual details *see also* SEC v. Franklin Atlas Corp., 171 F. Supp. 711 (S.D.N.Y. 1959).

Wilko v. Swan, 127 F. Supp. 55 (D. Conn. 1953). The court upheld a special jury verdict in which a director and stockholder was found not to be in a control relationship with Air Associates, Inc. *Id.* at 56-57, 60. The percentage of stock he owned was not disclosed.

⁷¹ See notes 68-70 *supra*.

shareholder as a control person, a quantification-intensity analysis leaves the status of many shareholders uncertain. To alleviate this uncertainty, it is urged that the control analysis utilize one final touchstone—the ability to obtain registration. Interjection of this norm into the control analysis would alleviate the present uncertainty surrounding the determination of who is a control person since it provides a consistent and objective point of reference by which to evaluate a selling shareholder's control bases. If, after isolating the shareholder's bases, it is reasonable to assume that he has the power to demand registration or persuade those who have the power, he is a control person. Indeed, an analysis based on the facts and outcome and not the language of many reported cases suggests that some courts do interject this norm into the analysis, since those cases *generally* are consistent with the notion that a shareholder with the ability to obtain registration is a control person.⁷²

⁷² This conclusion is drawn from an analysis of the cases discussed at notes 68-70 *supra*. Rule 160 of the Wheat Report, SEC Disclosure Group, "Disclosure to Investors—A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts," CCH FED. SEC. L. REP. app. VI-1 (1969) [hereinafter cited as the Wheat Report], which has not been adopted, excluded from the definition of control person a seller who was not an officer, director, 10% shareholder, or person with a substantial relationship to any of the foregoing. See note 102 *infra*. A note to Rule 160 gives examples of situations in which persons with some bases for control should not be considered control persons. Those examples support the inference that the ability to obtain registration is important.

Example one: Dr. A, a distinguished chemist, is "vice president in charge of research" of the X Company, a producer of chemicals. The extent of Dr. A's participation in the management of the business as distinguished from the scientific side of the company's affairs is limited to advising the other officers and occasionally the directors as to the commercial feasibility of possible new products and processes. Dr. A is not a director of the company nor is he related by blood or marriage to any of its directors or officers. His holdings of X's voting securities (when computed in accordance with this rule) do not reach the 10% level referred to therein.

Although Dr. A may be an executive officer of the X Chemical Company, he is not a person "directly or indirectly controlling" the company for purposes of Section 2(11) of the Securities Act. Since his role in the company is purely scientific, his influence over its management and policies is insufficient to be deemed controlling for Securities Act purposes. The result might be different if X were primarily a research organization as, for example, if it were primarily in the business of doing chemical research for others on a fee basis.

Example two: Messrs. C and D are directors of Z Company. They represent a group which owns about 20% of Z's voting securities. Another group associated with the Z family and with Z Company's executives owns 55% of Z's voting securities. Messrs. C and D have no allies on Z's 11-man board of directors. They owe their directorship solely to the fact that Z's certificate of incorporation provides for cumulative voting and they have been unable to get the board to accept their proposals.

C and D are not in control of Z.

Example three: Mr. E is the publisher of the leading daily newspaper in the city of K. Although journalism is his principal occupation, Mr. E also spends much time and energy in civic work and is regarded as one of the city's prominent citizens. At the request of its president, Mr. E has be-

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

III. BASES FOR GROUP CONTROL

A number of court and administrative decisions have recognized that membership in a control group requires that a person who lacks individual control of a corporation nevertheless be treated as a control person.⁷³ This treatment is consistent with the House of Representa-

come a director of the K Machinery Company, one of the largest employers in K. The management of the machinery company wanted Mr. E on the board because it valued his demonstrated business judgment and knowledge of the community. Mr. E is unrelated to the officers or principal stockholders of the machinery company. He holds approximately 2% of the company's outstanding common stock. He spends relatively little time on the company's affairs apart from attendance at directors' meetings. He is not an officer of the company.

On these facts, Mr. E is not a controlling person of K Machinery Company.

Example four: Mr. and Mrs. E and their children sold their family-owned business to the X Corporation several years ago. As a result of that transaction the E family acquired 25% of X's stock. Mr. E thereupon retired from business to devote himself to various charitable endeavors in which he had long been interested. Neither he nor any member of his family serves as either an officer or a director of X Corporation. X Corporation's officers occasionally consult Mr. E with respect to the affairs of the segment of the corporation's business formerly operated by Mr. E. The Corporation's voting securities are held as follows:

Mr. E and his family	25%
Public investors	22%
The X family, which consists of the descendants of the founder of X Corporation and whose members act as a unit	53%
TOTAL	100%

It is reasonably clear that the X Corporation is controlled by the X family and that in spite of its substantial holdings the E family has no dominion over the enterprise. Accordingly, the members of the E family are not deemed to be controlling persons of X Corporation for '33 Act purposes.

Example five: Mr. F, the founder of F, Inc. was its president for many years. He still owns 25% of F, Inc.'s voting securities. Some years ago however, Mr. G, an investment banker and a group of his associates accumulated about 45% of F, Inc.'s stock. The balance of the stock is widely distributed. As a result of a proxy contest between Mr. F and his friends, on the one hand, and the G group on the other, the founder and his closest associates were removed from the board and from their executive positions with the company. The present board consists of Mr. G, his nominees and two representatives of institutional investors who hold substantial blocks of the company's securities and were allied with Mr. G in the proxy contest.

Mr. F has ceased to be a controlling person of F, Inc.

Id.

⁷³ See, e.g., U.S. v. Wolfson, 405 F.2d 779, 781-82 (2d Cir. 1968); U.S. v. Dardi, 330 F.2d 316, 325 (2d Cir. 1964); SEC v. American Beryllium & Oil Corp., 303 F. Supp. 912, 915 (S.D.N.Y. 1969); SEC v. Micro-Moisture Controls, Inc., 167 F. Supp. 716, 718, 738 (S.D.N.Y. 1958); *aff'd sub nom.* SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959); *In re Thompson Ross Sec. Co.*, 6 S.E.C. 1111, 1119-20 (1940).

tives Committee Report, which stated that the distributor of securities should be treated as "equivalent to the original issuer" where a controlling interest is "owned by one individual or a select group of individuals."⁷⁴ The determination of whether a group exists is the same as the determination of whether there is a significant relationship between a selling shareholder and another party. In both, the question should be: is there such a relationship between the selling shareholder and another person or persons that it is reasonable to presume that the selling shareholder can enlist the help of the other person or persons in securing registration. If that relationship exists, the characteristics of the person or group of persons should be imputed to the selling shareholder. Thus, for example, if a group consists of three members, each of whom has 10 percent of the voting stock, each would be treated as if he owned 30 percent of the voting stock.

Although it is clear that characteristics of the entire group are to be attributed to each member, the factors that generate the existence of a group are uncertain. A number of legal scholars and experts in the area have sought to develop a workable norm by which to characterize group control. For example, in stating what they consider to be the clearest case of group control, two commentators have written that "there is no controversy" over the fact that "control may be exercised by a cohesive group working together."⁷⁵ Former Commissioner Sommer expressed a similarly general view, suggesting that "there must be some homogeneity among individuals if they are to be regarded as members of the controlling group, some significant business characteristic or relationship or course of conduct that affords an element of unity."⁷⁶ It also has been said that "an essential element of a controlling group is a demonstrated propensity to act together in concert with respect to the exercise of the group's power to control."⁷⁷ None of these statements, however, provides a workable norm for defining a control group. While all of them appear to require some unity of action, none indicates the type of unified conduct that would cause a court to find a group. Would any of the above commentators suggest, for example, that there was a group simply because four shareholders had gotten together to raise money for the Cancer Fund? Would the result be different if they agreed at a shareholder's meeting that the corporation should attempt to obtain new financing from a bank or if there had been unanimous agreement on all corporate issues since the incorporation of the business?⁷⁸ Do any of these

⁷⁴ H. R. REP. NO. 85, 73d Cong., 1st Sess. 13-14 (1933).

⁷⁵ Enstam & Kamen, *supra* note 36, at 308.

⁷⁶ Sommer, *supra* note 64, at 577.

⁷⁷ 9 ALR Fed. 639, 661 (1971).

⁷⁸ One commentator has stated that "if [a shareholder] has always worked in conjunction with the other members of the board who are definitely in control and has never opposed management, I think he would be considered a controlling person." Israels, *supra* note 65, at 10.

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

activities demonstrate such unity that a shareholder should be required to register his stock prior to sale?

To answer these questions, a close analysis of the cases in which the group notion has been used to declare that a particular entity was a control person may be helpful.⁷⁹ However, since these cases contain neither a generalized nor workable norm for calculating an individual's status as a group member, the utility of such an analysis lies in isolating the factors which have been most often emphasized as bases for declaring an individual a member of a control group. A number of cases have found a group in instances where shareholders have worked in concert to distribute their stock. In *United States v. Dardi*,⁸⁰ for example, the Second Circuit found that three persons were a controlling group for purposes of section 2(11), where the three individuals had formed a "partnership . . . for the purpose of merging Frankling [County Coal Company] . . . with a company listed on either the New York or American Stock Exchange and then selling the stock of the listed company as thus acquired."⁸¹ In *S.E.C. v. Micro-Moisture Controls, Inc.*,⁸² the court found that a control group existed apparently because a group of individual shareholders, who had received Micro stock when their company merged with Micro, had joined forces to effectuate a distribution of their unregistered Micro stock.⁸³ These shareholders had gone so far as to deliver to one person irrevocable powers of attorney to sell the stock.⁸⁴

The outcome of the *Thompson Ross Securities Co.*⁸⁵ proceedings is similar to the results reached by courts in the *Dardi* and *Micro-Moisture* cases. In *Thompson*, the Commission found that three individuals who controlled 97 percent of the stock of Continental Cushion Spring Company constituted a control group for section 2(11) purposes. While the basis for the group is not readily apparent, it appears to rest on the fact that the group members agreed to act together in the distribution of their stock. At one point, the Commission stated: "There can . . . be no question that the registrant [Thompson Ross Securities Co.] purchased the shares which it initially distributed from a 'select group of individuals' who controlled the issuer. . . . Their common aim was to further registrant's distribution to the public."⁸⁶

Thus, in *Dardi*, *Micro-Moisture* and *Thompson Ross*, a group was found apparently because the individual shareholders had agreed to

⁷⁹ See text at notes 80-91 *infra*.

⁸⁰ 330 F.2d 316 (2d Cir. 1964).

⁸¹ *Id.* at 321-22.

⁸² 167 F. Supp. 716 (S.D.N.Y. 1958), *aff'd sub nom.* SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959).

⁸³ 167 F. Supp. at 738.

⁸⁴ *Id.* at 721.

⁸⁵ 6 S.E.C. 1111 (1940).

⁸⁶ *Id.* at 1119. In SEC v. International Chem. Dev. Corp., 469 F.2d 10 (10th Cir. 1972), Frank Parks was held to be part of a group controlling International Chemical. The principal basis for this holding appears to be the fact that Parks distributed stock "at the behest of and in combination with Cardall, an issuer." *Id.* at 32.

cooperate in their distribution of a substantial amount of stock through an underwriter.

This is not the only situation, however, in which a control group has been found to exist. *Pennaluna & Co. v. S.E.C.*,⁸⁷ for example, demonstrates that cooperation in other matters can lead to a determination that a group exists. In that case, the Ninth Circuit found that Harry F. Magnuson was in control of the Silver Buckle Mining Company because he was part of a control group. In so finding group status, the court based its determination on a number of factors. First, Magnuson was on the board of directors of two companies controlled by Silver Buckle.⁸⁸ Second, Scott and Hull, two of the four persons the court characterized as "unquestionably in control of Silver Buckle," had accounts with a securities firm in which Magnuson had a 37.5 percent ownership.⁸⁹ In addition, Hull was attorney for Magnuson and Magnuson's securities firm.⁹⁰ Finally, the other members of the group had utilized Magnuson to place a substantial block of Silver Buckle stock in "friendly" hands.⁹¹ Thus, it is apparent that a network of business relationships can lead to a determination that a control group exists.

The fact patterns in *Dardi*, *Micro-Moisture*, *Thompson Ross* and *Pennaluna* are not exhaustive of the instances in which an individual may be deemed a member of a control group. For example, a director could be deemed part of a group consisting of the board of directors.⁹² Likewise, a family member could be deemed to be a member of a group consisting of all the members of her family.⁹³ The problem with the control group cases, however, is that the typical analysis is deficient. A control group approach needlessly confuses the control analysis by focusing on group membership. A more understandable approach would be simply to inquire whether the selling shareholder has the ability to obtain registration. If it is reasonable to

⁸⁷ 410 F.2d 861 (9th Cir. 1969).

⁸⁸ *Id.* at 866.

⁸⁹ *Id.* at 863, 866 n.4.

⁹⁰ *Id.* at 866 n.4.

⁹¹ *Id.*

⁹² Former Commissioner Sommer has said that "unless a person or identifiable group clearly is in control by reason of possession and use of voting power, all directors and policy-making officers are presumptively members of the controlling group and only compelling evidence to the contrary should remove them from the group." Sommer, *supra* note 64, at 577. For a suggestion that status as a director raises no presumption of control but rather that it should be "regarded as a red light," see Israels, *supra* note 65, at 11. See also II L. LOSS, SECURITIES REGULATION 781 (1961).

⁹³ Sommer, *supra* note 64, at 580.

[I]t is probable that in most cases all members of a family would be regarded as prima facie members of the controlling group if by acting in concert they would have the power to control the issuer, or if some member of the family who alone lacked the power to control nevertheless exercised control. However, it is not difficult to imagine circumstances which would be effective in rebutting such a prima facie suggestion.

Id.

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

expect that the selling shareholder could obtain registration, he is a control person. One's ability to obtain registration, in turn, can be based on a single relationship or a network of relationships with others who have some power.⁹⁴ Thus, the focal point of the control analysis should be the nature of the selling shareholder's relationship with others involved with the corporation rather than the existence of a group and membership in that group. For example, a woman may be classified as a control person because her son and husband own a majority of the voting stock in a particular corporation.⁹⁵ She is a control person because she reasonably could be expected to enlist the aid of her family in obtaining registration. To say that she is a control person because she is a member of a group consisting of the family is to confuse the analysis needlessly.

Approaching the question of whether one is a control person by inquiring into the particular seller's ability to obtain registration results in some clarity. Past relationships and cooperation remain important, but past dealings are not utilized as a basis for finding an answer to the ultimate question of whether there is a control group. Rather, the past relationships are important as a basis for determining that the selling shareholder could enlist the cooperation of others in procuring registration. In the same manner, family relationships are also important. Analytically, however, it is critical to realize that the ultimate question is different. It is not whether there is some ephemeral body called a "group," the existence of which makes a member subject to certain special rules; rather, the question is whether a selling shareholder can, either by direct relationship with the issuer or by a relationship with other entities that have some power over the issuer, obtain registration.⁹⁶

This same type of analysis is helpful even if one defines control as the power to direct management. Only the ultimate question changes. The power to direct management can come from various sources, including a relationship with other individuals who have power. That relationship may enable him to persuade the other individuals to act on his behalf with respect to the management of the company. An analysis which focuses on whether the selling shareholder has a relationship with individuals who have the power to direct management is deficient, however, because it is unclear⁹⁷ and is not

⁹⁴ See text at notes 64-67 *supra*.

⁹⁵ This "attribution" concept is also used in determining beneficial ownership under § 16 of the Securities Exchange Act of 1934, 15 U.S.C. § 78p (1970). 31 Fed. Reg. 1005 (1966).

⁹⁶ At least one court appears to have adopted this type of analysis. In *Pennaluna*, 410 F.2d at 866, the court seemed to say that prior relationships between Magnuson and members of a control group caused Magnuson to become a control person, apparently because those relationships "strongly suggest[ed] his ability to insist upon registration."

⁹⁷ See text following note 22 *supra*.

philosophically consistent with the congressional intent underlying the imposition of the registration requirement on control persons.⁹⁸

IV. A TECHNIQUE TO REMEDY THE PRESENT UNCERTAINTY

Notwithstanding the fact that certain general conclusions about the definition of control can be drawn, the uncertainty that presently surrounds the question of who is a control person should not be underestimated. Since the Commission has refused to remedy this uncertainty,⁹⁹ the courts must fill the vacuum. This task should be approached with a determination to reduce uncertainty and increase philosophical consistency.¹⁰⁰ Two responses would serve to both re-

⁹⁸ See text at notes 19-22 *supra*.

⁹⁹ See text following note 22 *supra*.

¹⁰⁰ Other statutes impose additional constraints and apply various special rules to persons in control. See, e.g., Securities Exchange Act of 1934, 15 U.S.C. §§ 78a through jj (1970); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 through 80a-52 (1970); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa through 77bbbb (1970); Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79-79z-6 (1970). Commentators generally accept cases arising under other statutes as at least persuasive authority in secondary distribution cases. As one pair of commentators has said, "[A] precedent in one area, while not conclusive in other areas, has considerable value as an analogy." Enstam & Kamen, *Control and the Institutional Investor*, 23 BUS. LAW. 289, 305 (1968). See also Sommer, *supra* note 64, at 576. In at least two instances, the Commission has indicated that it will consider definitions of control that have arisen in other statutory settings as persuasive. In *In re The M.A. Hanna Co.*, 10 S.E.C. 581 (1941), the Commission was faced with the question of whether the National Steel Corporation was controlled by Hanna. The issue arose in the context of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-52 (1970). In reaching its decision that Hanna was not an investment company, the Commission relied on cases arising under the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 through 79z-6 (1970). In defending the use of those cases as precedent, the Commission stated that

[W]hile this phrase . . . must be construed in the context in which it is used and in the light of the general regulatory purposes of that Act, which are not necessarily the same as those of the Investment Company Act, these decisions are nevertheless entitled to weight as significant analogies.

In re The M.A. Hanna Co., 10 S.E.C. 581, 589 n.13 (1941). See also, *In re The Chicago Corporation*, 28 S.E.C. 463 (1948).

Notwithstanding the foregoing, it is submitted that cases arising under other statutes, or other sections of the 1933 Act should be considered of limited value in secondary distribution cases. The purposes of the various acts dictate that different types of entities be classified as control entities and accordingly subject to the special rules under each act. For example, under the Trust Indenture Act, 15 U.S.C. §§ 77aaa-77bbbb (1970), an indenture trustee is disqualified from that position if he is under the control of the issuer, 15 U.S.C. § 77jjj(b)(3) (1970). (For an excellent discussion of the control concept in the context of the Trust Indenture Act, see *In re J.P. Morgan & Co.*, 10 S.E.C. 119 (1941)). In determining whether a particular proposed trustee has such a relationship with the issuer, secondary distribution cases should have little significance. The purpose for requiring registration of secondary distributions is so foreign to the purpose for the control concept in the Trust Indenture Act that it is of little precedential value in determining whether the quantity or quality of control is significant enough to require registration.

Cases from other areas are valuable to the extent they indicate bases of control. Thus, for example, the fact that one is a substantial shareholder of a company would probably be evidence of control under any act. When, however, one is faced with the

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

duce uncertainty and increase philosophical consistency: the adoption of the ability to obtain registration norm as the definition of control and a re-evaluation of the bases for control in light of that definition.

The key to re-evaluating the bases for control lies in recognizing that control, which is defined as the ability to obtain registration, can be based on either power, or persuasion, or both. A selling shareholder may be in control of a corporation either because he has the power to demand registration or, alternatively, because he has the ability to persuade those with power to demand registration for him. One quite obvious basis for the power to demand registration is ownership of voting securities. Thus, if a shareholder owns 51 percent of a corporation's voting stock, he has the power to demand registration. Additionally, the power to demand registration could be secured through contractual rights. If, for example, a corporation and its officers and directors have contractually obligated themselves to accede to a request by A to file a registration statement, A would appear to have the power to demand registration and, accordingly, would be a control person. Proxies could also give a shareholder the power to demand registration, particularly if the shareholder controlled a majority of the corporation's stock by proxy. Finally, a management position could generate some power to obtain registration. Yet, a single management position alone does not create sufficient power to demand registration. Such a position generates only the power to obtain one signature and some of the information necessary for registration. It does not *guarantee* that all the information and signatures necessary for registration are available.

These examples of the various possible power bases of control are not necessarily exhaustive. Generally, it should not be especially difficult to determine whether a selling shareholder has the power to demand registration. It is simply a question of the shareholder's raw power to secure the necessary signatures and information. If, through a combination of factors, such as voting rights, contractual rights, proxies and management position, he has the power to obtain registration, he is a control person.

Although determining whether or not a shareholder has the power to demand registration is relatively simple, determining whether a selling shareholder has the ability to obtain registration by persuasion is more difficult. Conceptually, the issue is whether the selling shareholder has such a significant relationship with a second entity that it reasonably may be assumed that he could enlist the help of that entity in obtaining registration. If such a relationship exists, the characteristics of the second entity will be imputed to the selling

more difficult question of determining whether a particular conglomerate of facts constitutes control, cases arising under other statutes generally are of little help. Indeed, Former Commissioner Sommer stated: "decisions under other statutes must be examined cautiously, analytically, discriminatingly before concluding they apply on all fours in situations arising under the '33 and '34 Acts, or before rejecting them as without significance." Sommer, *supra* note 64, at 576.

shareholder. Thus, for example, if a selling shareholder has 26 percent of company X's stock and a second entity with whom he has a significant relationship owns 25 percent, the selling shareholder would be treated as if he were a 51 percent shareholder of X.

The mechanics of a persuasion analysis are not especially complex. The difficulty lies in determining what situations make it reasonable to assume that the second entity would aid the selling shareholder if the shareholder wanted the company to file a registration statement. Here, relationships obviously play an important role. It is necessary to evaluate personal, business and family relationships to determine whether it is reasonable to assume that the selling shareholder could obtain registration by enlisting the help of other entities. Since evaluating relationships involves an especially difficult and subjective judgment, it may be appropriate for courts to develop certain presumptions. For example, it may be appropriate to presume that a member of a household could obtain the aid of the other members in securing registration.¹⁰¹ Likewise, persons who have had past, extensive business associations would seem to be able to secure the assistance of each other in obtaining registration.

The proposed power-persuasion analysis requires a thorough evaluation of a selling shareholder's characteristics. He may have a single basis for control, or he may have multiple bases. In the latter instance, the cumulative effect of his power factors and of his persuasion factors must be evaluated. The ultimate consideration, however, remains constant: Is it reasonable to assume that the shareholder could obtain registration? Although this proposed analysis does not remove all uncertainty, it does mitigate the ambiguity that presently surrounds the question of who is a control person. A philosophy which is consistent with the congressional intent underlying imposition of the registration requirement is also thereby established. The bases for power do not appear especially difficult to isolate. The persuasion bases, on the other hand, remain somewhat unclear since those bases rest on a myriad of human relationships. Explication by the courts and commentators, however, could aid in eliminating much of the uncertainty.

Nevertheless, even if the entire judiciary were to adopt the proposed analytical framework, due in part to congested court calendars the necessary development and clarification of the applicable principles would be a slow process. Thus, there would be interim uncertainty. Moreover, even after the judiciary has had time to develop the area, a substantial residuum of uncertainty would remain. In particular, some uncertainty would continue to surround the definition of the bases of persuasion, since those bases rest on a fragile network of human relationships. The ultimate solution to the uncertainty over who is a control person, therefore, will likely require a legislative or

¹⁰¹ Rule 160 of the Wheat Report, note 72 *supra*, makes this presumption. See note 102 *infra*.

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

administrative response in the form of a statutory amendment or new rule. The Wheat Report proposed one rule, Rule 160.¹⁰² Stated in general terms, the approach of the Wheat Report is to exclude from the definition of a control person a seller who is not an officer, director, 10 percent shareholder or a person who lacks a substantial relationship to any of the foregoing.¹⁰³ Thus, if a selling shareholder has

¹⁰² Rule 160 of the Wheat Report, note 72 *supra*, states:

(a) The phrase "person directly or indirectly controlling . . ." as used in Section 2(11) of the Act, when the issuer is a corporation, shall be deemed not to include a person who

(1) is neither an executive officer nor a director of such corporation,

(2) does not perform the functions of an executive officer or director of such corporation,

(3) is not a person owning beneficially, or possessing voting rights respecting, securities representing more than 10% of the voting power of such corporation,

(4) is neither father, mother, child, brother, sister or unseparated spouse of any individual referred to in (1), (2) or (3) above,

(5) is not a creditor of such corporation whose consent is presently required, or may be required under circumstances within his control, before changes in the management of the corporation, or other corporate transactions (apart from payment of dividends, increase in or extension of indebtedness, or the like) may take place.

(b) For the purposes of this rule, the term "executive officer" means the president, secretary, treasurer, any vice president in charge of a principal business function (such as sales, administration or finance) and any other officer who performs similar policy-making functions for the registrant.

(c) As used in (a)(3) above, the term "person" shall include (1) an individual, (2) his spouse and minor children, (3) any relative of such individual or of his spouse who has the same home as such individual, (4) any trust or estate in which such individual, his spouse, any of his or his spouse's minor children, and any relative of such individual or of his spouse who has the same home as such individual, collectively have a substantial beneficial interest or as to which any of the foregoing serves as trustee, executor, or in a similar fiduciary capacity, and (5) any corporation or other organizations controlled by such individual, his spouse, any minor child or of such individual or of his spouse, or any relative of such individual or of his spouse who has the same home as such individual.

(d) In computing the number of outstanding voting securities of any class held by a person and the total number of all outstanding voting securities of such class, the following shall be included: (1) outstanding securities of the class, (2) all securities of the class into which other securities beneficially owned by such person are convertible or may (after the passage of time or upon the happening of any event) be convertible, and (3) all securities of the class which such person has any call, option, or other contract right to acquire.

Note: This rule is not intended to imply that persons who do not come within its terms are for that reason deemed to be "in control" of an issuer. Thus, depending upon the circumstances of the individual case, a person who is a director or who owns more than 10% of the voting securities of a corporation may nevertheless not be "in control" of such corporation.

Id.

¹⁰³ See *id.*

none of these qualities, he is excluded from the definition of control. On the other hand, if he possesses one or more of these characteristics there is no presumption that he is a control person; rather, it appears that a determination of whether he is a control person rests on case law, rules and statutes in effect at the time of his sale.

It is submitted that proposed Rule 160 is unresponsive to the existing problem of uncertainty in the definition of control. Only in situations where a selling shareholder has none of the Rule's enumerated characteristics is he excluded from the definition of control. As the law presently exists, however, the absence of *all* of the factors delineated in the proposed Rule appears to eliminate any significant danger of control. Thus, the Rule adds nothing to clarity. Further, the Rule does not insure philosophical consistency, since it merely defines those individuals who might, upon further analysis, be treated as control persons. Thus, the rule simply adopts somewhat arbitrary norms, with apparent disregard for whether the selling shareholder can or cannot obtain registration.

It is submitted, therefore, that an amendment to the 1933 Act is the appropriate response to the problem of uncertainty. One benefit that would inure from a legislative solution to the problem of uncertainty is that it would provide an opportunity for a thoughtful re-evaluation and balancing of the complex values involved in a rule requiring registration by persons other than issuers, underwriters and dealers. One of the more pressing considerations toward which the rule is directed is the protection of the public from the sale of large blocks of stock where adequate information about the company is unavailable. Yet, it would seem unfair to apply significant constraints to small sales of stock by shareholders, for the cost of insuring compliance would be intolerable for most small shareholders and unnecessarily burdensome on corporations if they were required to comply with a registration demand each time a small block of stock changed hands. Moreover, imposing a significant restraint on the negotiability of such securities could have an adverse impact on the capital markets, since investors would be less likely to purchase stock if there are significant constraints on resale. The benefits of protective disclosure of information could be balanced against the pernicious effects of over-regulation, however, by imposing a constraint on secondary distributions only when the size of an anticipated sale creates significant dangers. For example, Congress might enact legislation making the Act's registration requirement applicable to sales by persons other than issuers, underwriters, or dealers only if the selling shareholder sells more than a certain amount of stock in any given period of time.¹⁰⁴ To guarantee fairness to the selling shareholder, Congress

¹⁰⁴ Existing Rule 144, 17 C.F.R. § 230.144 (1976), takes a similar approach. If a control person is able to meet the other requirements of the Rule, he can sell the lesser of "one percent of the shares of the class outstanding . . . or . . . the average weekly reported volume of trading in such securities on all securities exchanges . . . during the four calendar weeks preceding . . ." Filing of the required notice. *Id.* Rule 144, how-

DEFINING CONTROL IN SECONDARY DISTRIBUTIONS

also should insure that he can obtain registration, if it becomes desirable or necessary. A requirement that the issuer accede to a selling shareholder's demand for registration would provide the necessary insurance. Fairness also suggests, however, that in return the issuer should receive reasonable compensation for the costs of registration.¹⁰⁵

A further benefit of this legislative proposal is that it would serve to reduce uncertainty significantly. Currently, selling shareholders are treated unfairly because they are often unable to determine with any substantial degree of certainty whether they are subject to the registration requirement. This unfairness is exacerbated by the liabilities attached to a violation of the registration requirements.¹⁰⁶ The inequities of the present situation are further accentuated by the legal costs associated with the sale of a control block. With good securities lawyers charging *at least* fifty dollars an hour for their time, the legal costs associated with the sale of securities can be significant. Moreover, if the shareholder falls into the large grey area in which existence of control is uncertain, legal advice is guaranteed to be costly. Extra care on the part of the attorney translates into increased costs to the client.

The present uncertainty has other undesirable impacts as well. It has been stated that uncertainty provides "unfortunate leeway for the unscrupulous."¹⁰⁷ It should be added that it also provides unfortunate leeway for the reckless. Shareholders with a low respect for the law and a high propensity to take risks will fail to register. Conversely, those shareholders with a high respect for the law and a low propen-

ever, is not an adequate substitute for the proposals made in the text of this article. First, because of the Rule's specific requirements, it will not always be available to the control person. Secondly, the Rule does not insure that large sales of stock by shareholders will be subjected to the registration provisions. For example, if one assumes that a person with less than 10% of the stock of a corporation would not be considered a control person, a 9% shareholder could sell all his stock with impunity, while a 10% shareholder can sell only 1%. If the philosophy underlying the constraints on a control person is designed to protect against large blocks of stock being sold without proper disclosures, the constraints of Rule 144 do not work precisely. This becomes even more apparent when it is recalled that the same rules apply to the sales of General Motors stock and the stock of a small corporation. This means that a 9% shareholder of General Motors may be able to sell his stock, while a 10% shareholder of a small corporation would be able to sell only 1%.

¹⁰⁵ This statutory alteration would require modifications to existing statutes and rules. For example, Rule 144, 17 C.F.R. § 230.144 (1976), would have to be amended. See note 104 *supra*. Also, it might be appropriate for the Commission to make Rule 146, 17 C.F.R. § 230.146 (1976), which provides an exemption from registration for certain issues that do not involve a public distribution of securities, and Rule 147, 17 C.F.R. § 230.147 (1976), which provides an exemption from registration for "intrastate" offerings, available to shareholders subject to the registration requirements.

¹⁰⁶ Under § 12(1) of the Act, 15 U.S.C. § 771(f) (1970), failure to comply with the registration requirements generates rescission liability. Thus, if the selling shareholder sells one million dollars worth of securities, he is liable for that amount. Obviously, this factor increases the unfairness of the uncertainty.

¹⁰⁷ The Wheat Report, *supra* note 72, at 177.

sity to take risks will register. This result is unfair to the scrupulous risk-averter. It also is unsound as a policy matter. The shareholder is given unnecessary discretion to determine when registration is appropriate. Thus, the public's protection often is determined not by the need for registration but rather by the risk aversion tendencies of the selling shareholders. A legislative solution to the present uncertainty surrounding the question of who is a control person would thus provide an opportunity not only to re-evaluate and balance the complex values involved in imposing registration on control persons, but also would serve to eliminate the uncertainty and its undesirable by-products of high legal costs and unsound policy.

V. CONCLUSION

A few years ago, the Commission was vulnerable to a claim of callous indifference to the need for clarity in the 1933 Act. In the last five years, however, the Commission has made a major effort to reduce the Act's uncertainty in many areas. Specifically, the promulgation of Rules 144,¹⁰⁸ 146,¹⁰⁹ 147,¹¹⁰ 237,¹¹¹ and 240¹¹² has significantly reduced the Act's uncertainty. In one area, however, the Commission has been unexplainedly meek. The Commission has failed to clarify the circumstances under which persons, other than issuers, underwriters and dealers, are subject to the Act's registration requirements. The failure to act is perhaps due to the Wheat Report's unsatisfactory proposal.¹¹³ Nevertheless, the Commission should pursue its quest for understandable norms. To this end, at least two courses of action are available. The Commission could attempt to define the term control more precisely. Alternatively, it could recommend legislation similar to that advocated by this article. Whichever procedure is adopted, however, the need for affirmative action is clear.

¹⁰⁸ 17 C.F.R. § 230.144 (1976). See note 104 *supra*.

¹⁰⁹ 17 C.F.R. § 230.146 (1976). See note 105 *supra*.

¹¹⁰ 17 C.F.R. § 230.147 (1976). See note 105 *supra*.

¹¹¹ 17 C.F.R. § 230.237 (1976). This rule permits resales of restricted securities after five years.

¹¹² 17 C.F.R. § 230.240 (1976). This rule exempts from registration sales of a limited amount of stock by small corporations.

¹¹³ See text at notes 102-103 *supra*.