

We New Wizards of Wall Street

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Texas Bar Journal, 66 Tex. B. J. 120, February 2003

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With the advent of the internet access to instant stock market information, millions of us have opted to compete with the professionals and formulate our own investment strategies. We then act on our self-administered advice and actually place orders to buy or sell securities using software installed on our personal computers. For legal advice, we new wizards of Wall Street seek out, from the short list of "securities" lawyers, someone we hope is qualified. (More on that later). We have no clue about the details of these transactions or the role played by the brokers, the clearing agents, or the transfer agents in the purchase or sale of stock. It is further a virtual certainty that even the "securities" lawyers we have consulted are somewhat deficient in this regard. Events occurring "after the trade" are shrouded in mystery and thought by some to be poisonous. Twenty-five years ago Marcia Stigum wrote the book on this aspect of securities operations,¹ and that book remains the Gideon Bible for the uninitiated. The purpose of this article is to provide some basic information so that we may better understand what we have gotten ourselves into as investors and advisors.

¹ Stigum, "The Money Market" (1978) and Stigum, "After the Trade" (1986). I first encountered Ms. Stigum in the late 80's while handling a securities fraud case growing from the "Hillcrest Trading Scenario." That case involved an abuse of the "book entry" system applicable to trades in U.S. government T-bills and notes. Simultaneous buy and sell orders were executed by Hillcrest Securities, Inc. for its customers. This established a huge ordinary loss in the year of the trade, offset by an equally large capital gain in the next tax year. The problem was that the Broker on the other side of these transactions never had any T-Bills or Notes to deliver and didn't have the financial capacity to buy any. Hillcrest also purported to buy and sell repos and reverse repos for its customers in order to minimize the "risk" in an already "riskless" transaction. The paper-less, book-entry system permitted these events to go undetected for almost four years. From a technical standpoint the trading strategy was doomed from the outset because the interest payment was being made to the same entity that was loaning the money with which to make the payment.

Glossary

Before setting out on this adventure it might be helpful to define some of the terms and describe how they fit together.

- The "33 Act" is called the Securities Act. It deals with the requirements for the "registration" of securities (stock) with the Securities and Exchange Commission (SEC) before a public sale. It also describes the exemptions from registration. Section 3 of the 33 Act provides exemptions for particular kinds of securities, and Section 4 provides the transactional exemptions. Peculiarly the *intrastate sale* exemption is found in Section 3, not Section 4.

- The "34 Act" is called the Securities Exchange Act. It regulates the conduct of the people routinely involved in a securities transaction. It also defines the circumstances that require a company (not the shares of a company) to be registered with the SEC.

- "Unregistered" securities are those that have been issued without a 33 Act registration. Generally these are securities issued under a limited offering exemption from registration provided by Regulation D (Rules 501-506) and Regulation A (Rules 251-263), or a wholly intrastate offering exempted by Section 3(a)(11) of the 33 Act and Rule 147.

- "Restricted" securities are those that have been acquired in a transaction not involving a public offering. Private sales, founder shares, stock options, and the like fall in this category. The terms "registered" and "restricted" are not interchangeable.

- States are permitted to regulate securities transactions on a very limited basis. "Covered" securities, as defined in the National Security Markets Improvement Act (NSMIA), Section 18(b)(3) of the 33 Act, are not subject to state registration requirements.

- A "public offering" is an expansive concept usually involving a distribution of securities, at least in part, to unsophisticated purchasers. A public offering requires registration of the securities being sold.

- "Private offerings" are simply non-public sales or offerings. It is necessary, however, that extensive financial disclosure be made to or be available to any unsophisticated purchaser in a private offering.

- "Sophisticated," "accredited," and/or "qualified" generally describe an investor with assets in excess of \$ 1 million or annual income in excess of \$ 200,000. There are other qualifying criteria listed in Rule 215, but these are the most pertinent.

Now armed with the tools of the trade, we are ready to proceed.

The Law

The federal law comes in the form of legislation adopted in 1933 and 1934² and regulations issued thereto. While the concepts in those laws have been refined over time, the major focus remains DISCLOSURE. It was not the congressional intent to require that investors put their money only in good deals; rather Congress directed that investors should have all pertinent information available on a public company so that an investment decision could be made unencumbered by marketing hype or preening.³ This does not mean that a company cannot make speculative for-

² Securities Act of 1933, 15 USCA 77a-bb (33 Act) and Securities Exchange Act of 1934, 15 USCA 78a-mm (34 Act).

³ Charles Schneider said it best: "The basic protection of the Securities Act's registration provision lies in disclosure and not in protecting inappropriate purchasers from their own analytic or eco-

ward-looking statements, but it does mean that this safe-harbor had best be identified as such.⁴ In a general way Congress also made a decision that there were two types of investors. One group is comprised of the rich. The other includes the rest of us. The rich group, called accredited, sophisticated, or qualified investors, is thought not to need the acts' protection.⁵ For this reason there are numerous exceptions and exemptions to the law's application. The limited areas in which states are permitted to regulate relate in the main to stocks not listed on a National Securities Exchange.⁶ Texas and several other states impose certain substantive or merit requirements relating to the business plan of the company whose stock is being publicly offered.⁷ For example, any number of IPO's (initial public offerings) sponsored by fringe players from silicone valley and destined for OTC listing could not qualify for registration under Texas law because of the insubstantial nature of their business model.⁸ Indeed, if you happened to have purchased a dot.com in Texas, you most likely have a right of rescission.⁹ Another example of the scope of the Texas regulations is the requirement that some or all of the money raised in a public offering here may be ordered escrowed by the Commission if the company is not operating profitably at the time of the offering.¹⁰

The Players

The players in this arena are the broker-dealer, the clearing facility, and the transfer agent. The role of the broker is to purchase and/or sell stock for a customer. But the broker, as the first line of defense against fraudulent transactions, has many other tasks as well. Brokers must be registered with the SEC and the state authority in the state in which they operate. If the broker also functions as a dealer there are numerous provisions regulating that activity. A common misconception is that dealers act as a market maker for stock that they handle. The fact is that a dealer will usually act as a market maker only for stocks not listed on a National Securities Exchange (excluding the Nasdaq National Market).¹¹ On the NYSE and AMEX the market maker is a designated and registered spe-

conomic incapacity." See Schneider, Section 4(1/2). *Private Resales of Restricted or Control Securities*, 49 *Ohio St. L. J.* 501, 516 N. 41 (1988).

⁴ 15 *USCA* § 77z-2. There are extensive exclusions from this safe harbor. For example, it is inapplicable to penny stocks. 77z-2(b)(C).

⁵ An accredited investor is defined by Rule 215, 17 *CFR* § 230.215: Various banks, savings and loans, trusts, etc. with assets greater than \$ 5 million and/or individuals with a net worth greater than \$ 1 million or earnings greater than \$ 200,000 per year or \$ 300,000 if both spouses are involved. A qualified investor is as yet undefined. The SEC has recently proposed to define a qualified investor the same as an accredited investor. See Proposed Rule, Release No. 33-8041; File No. S7-23-01.

⁶ The SEC has actually explained the exclusions from state regulation. See *Report on Uniformity of State Regulatory Requirements for Offerings That Are Not "Covered Securities"*, issued pursuant to the National Securities Market Improvement Act of 1996. A copy can be found at <http://www.sec.gov/news/studies/uniformity.htm>.

⁷ See *Tx. Civ. Stat.*, Art. 581-7. Subsection (B)(1) requires net yearly earnings for three years equal to 5 percent of the value of all securities issued, including those to be sold in the offering, valued at the offering price. Subsection (C)(2) requires a business plan that is "fair, just and equitable."

⁸ See *Tx. Civ. Stat.*, Art. 581-10(A).

⁹ An absolutely exhaustive discussion of state remedies can be found at 50 *Baylor L. Rev.* 99, Rowley, *The Sky is Still Blue in Texas: State Law Alternatives to Federal Securities Remedies* (1998).

¹⁰ *Tx. Civ. Stat.*, Art. 581.9.

¹¹ The specialist must be designated by and registered with the exchange. AMEX does permit lim-

cialist operating on the floor of the exchange. The same is true for the larger regional exchanges. This specialist matches orders to buy and sell, and he maintains the orderliness and stability of the market by his own purchases and sales.¹²

The clearing facility is the bookkeeper, and its activities became simplified with the establishment of electronic trading for uncertificated stock. Indeed, the National Association of Securities Dealers (NASD) now requires its members to use uncertificated transactions if available for the stock being traded.¹³ This is the book entry system, and the major player is Deposit Trust Corporation (DTC). The first step is for Broker A to establish a long position deposit with DTC using stock provided by a customer with the customer's approval for it to be titled in "street name." A typical transaction then begins with a communication from Broker A to DTC that its customer has sold shares of uncertificated stock to a customer of Broker B. DTC then debits the account of Broker A and credits the account of Broker B. The stock itself is held in "street name" by Cede Corporation as custodian for DTC, and in this usual transaction the stock doesn't go anywhere. DTC's primary task is to see that its book balances at the end of the day.

The transfer agent is charged with the responsibility of keeping the stock records of its client (the company whose stock is being traded) in good order. In the transaction described above, the transfer agent will note in the transfer ledger a change in share ownership from Broker A to Broker B. It will not know the identity of the actual seller or purchaser.¹⁴ It is the responsibility of the brokers to keep track of the actual owner and to distribute dividends, proxy solicitations, and other communications from the company to that owner.¹⁵

The completion of a purchase or sale on the Over The Counter Market (OTC) is governed by T + 3, a fairly recent regulation from the SEC.¹⁶ Actually the regulation prohibits a broker from entering into a contract with a customer that permits settlement more than three days after the date of purchase or sale. Closure of transactions on the National Securities Exchanges are governed by similar rules adopted by the exchanges, under the guidance of the SEC.¹⁷ If a customer fails to make a deadline the rules of "buy-in" and "sell-out" come into play. Buy-in occurs when a customer fails to deliver to the broker the stock that was sold. The broker must commence the process of buy-

ited floor-trading activity by registered market makers. Rules American Stock Exchange, Rule 110. NASD has recently sanctioned the use of the Primex Auction System in the Nasdaq market. NASD Rule 5010, *et seq.*

¹² The history of auction exchanges is available on the Internet. It must be supposed that the restriction of trading activities on an auction exchange to a designated specialist, who incidentally must be a member (hold a seat) of the exchange, was intended to provide a financial benefit to the members of the exchange. It is commonly thought that this mechanism creates a more orderly market than exists with other forms of exchanges.

¹³ See NASD Rule 11310(d).

¹⁴ An explanation of the uncertificated system is covered by Emily Osiecki, *Alabama Byproducts Corp. v. Cede & Co.: Shareholder Protection Through Strict Statutory Construction*, 22 Del. J. Corp. 221 (1997).

¹⁵ *Id.* at pp. 223-227.

¹⁶ 17 CFR 240.15c6-1.

¹⁷ *E.g.*, Rules American Stock Exchange, Rule 510; Rules New York Stock Exchange, Rule 64(a)(3).

ing sufficient shares to cover the non-delivery within 10 days.¹⁸ A sell-out is a bit different. Here the broker will need funds to pay for the stock its customer purchased but failed to pay for. The broker must commence selling available assets of the defaulting purchaser in a similar but shorter timeframe. We can refer to this time limit as SC + 2 (settlement cycle plus two days--normally a total of five days).¹⁹ It should be of some interest that, as between Brokers, transactions must be covered (concluded) within 30 days.²⁰ I have not looked at what happens to the non-defaulting customer, but my guess is that the brokers pay to or note delivery to *their* customers just as if nothing were amiss.²¹

The Challenge

Now that we are experts in securities law, let's see if we can complicate things with a specific example: DF (a rich good ole boy), in exchange for blue collar services, receives 2,000 newly-issued shares of stock in Crooked Company, Inc. (CC), on Dec. 1, 1999 (a private sale). CC has 10,000 shares issued and outstanding by means of a 504 (one of those limited offering exemptions discussed previously in the Glossary) (*17 CFR 230.504*) offering, and its stock is listed on the OTC (pink sheets). DF is not an officer, employee, or director of the company. The stock issued to him contains no restrictive legend. The stock, however, is clearly restricted because it was acquired by DF in a transaction with the issuer not involving a public offering.²² We'll discuss the importance of this in a bit. On Dec. 2, 2000, DF decides to sell some of this stock. He sells 200 shares directly to friends and family (a private sale) and places 100 shares with his stockbroker to sell into the public market (an unsolicited public sale). At this point the COO of CC discovers (so he says) that DF may not have performed all the blue-collar services required by his contract, and immediately convenes the board of directors to cancel DF's stock. COO also contacts the transfer agent in order to stop any transfer of DF's shares. And, indeed, when the private sale stock arrives for transfer, the transfer agent declines to process the transaction. DF's open market sales (unsolicited public sales) are also rejected by the transfer agent. DF's broker then tells him that the shares he provided to cover the open market sales could not be transferred, and that, therefore, there was a failure to deliver. The broker next gives DF the really bad news: DF must provide 100 transferable shares immediately or else the broker will have to buy-in shares to cover these public market sales. To make matters worse, DF is then put on notice by a lawyer representing the friends and family that those good folks are going to sue him for the difference between what they paid for the stock and the current market price, which just happens to be \$ 10 per share higher than their purchase price.²³ At

¹⁸ 17 CFR 240.15c3-3m.

¹⁹ 12 CFR 220.4c3. This is the infamous Regulation T, adopted by the Board of Directors of the Federal Reserve System, applicable to margin transactions, and 12 CFR 220.8d for cash transactions.

²⁰ *17 CFR 300.302*. This is the time for reporting a default.

²¹ The good ole boys tend to cover each other.

²² Rule 144 defines "restricted stock" as stock acquired from the issuer or an affiliate of the issuer in a transaction or chain of transactions not involving a public offering. *17 CFR 230.144(a)(3)*. Also included are transactions subject to Rule 502(d), Rule 144A, Regulation CF, and Rule 901 or 903 under Regulation S.

²³ The damages in a case like this are the difference between the purchase price and the highest intermediate price achieved after the failure to deliver is discovered and for a fair period thereafter. *E.g., Miga v. Jensen*, 25 SW 3d 370 (Tex. App. - Ft. Worth 2000, review granted). The idea is that the purchaser could reasonably be expected to replace the stock in order to mitigate damages after a

this point things get out of control. DF receives notice from the State Securities Commission that he has violated state law by failing to register his shares with the commission before reselling them. The final event in this tragedy occurs when CC's listing on the Over the Counter Market (OTC) is cancelled because of its failure to provide sufficient financial information, and the stock becomes worthless. Well, who wins what and why? Without attempting to uncover complete answers, we will now take a look at some rules, regulations, and statutes:

Some Answers

1. Federal law prohibits, in most circumstances, a state from imposing substantive restrictions on the registration and sale of securities. This prohibition is applicable to the sale from CC to DF because this stock, although not listed on a national securities exchange, falls under a transactional exemption from state control.²⁴

2. DF's two transactions with others did not have to be registered with the Texas Securities Commission because of exemptions provided by state law.²⁵ The first was a private sale to friends and family.²⁶ The second was an unsolicited broker transaction.²⁷

3. As far as federal registration is concerned, DF's sales to friends and family were probably exempt as long as adequate financial information about the company was available or made available. The sales by the broker were exempt if they were unsolicited and the number of shares sold did not run afoul of Rule 144.²⁸ This rule permits, after an initial one-year holding period, sales, by a broker acting for an affiliate or a non-affiliate, in amounts up to one percent of the total issued and outstanding shares of the company, in a three-month moving window.²⁹ In aggregating this one percent, private sales are excluded.³⁰ After two years of owning restricted stock, the resale limitations

reasonable time period. The Texas Supreme Court recently reversed *Miga*, rejected the generally accepted view, and announced a contract damage rule. The decision has not yet been released for publication. *Miga v. Jensen*, 2001 WL 34038821 (Oct. 31, 2002).

²⁴ 15 USCA 77r(b)(3) and (4)(A). Private sales by an issuer to an "accredited" purchaser are not subject to state regulation, except a state may require filing of substantially the same documents filed with the SEC.

²⁵ The state exemption for private sales by an issuer would not be available because of the large number of stockholders. Tx. Civ. Stat., Art. 581-5(I)(a) and (c).

²⁶ Tx. Civ. Stat., Art. 581-5(c)(1). Case law seems to say that "private sales" are simply not included in the regulatory scheme. See *Joachim v. Magids*, 737 SW 2d 852, 855 (Tex. App.--Houston 1st, 1987, writ denied). The court erroneously cites Art. 581-5(I) in support of this conclusion. However, there is no reason why Texas could not adopt the same rationale as the federal system and engraft a Section 4(1 1/2) exemption into the state laws application. Discussion of 4(1 1/2) is beyond the scope of this article. For now, we simply observe that no such subsection appears in the statute. See generally, Berkeley, et al., *Private Resale of Restrictive Securities: The Section 4(1 1/2) Exemption*, SC61-ALI-ABA 323 (1998).

²⁷ Tx. Civ. Stat., Art. 581-5(O).

²⁸ 17 CFR 230.144.

²⁹ There are additional formulas linked to trading volume to determine the maximum number of shares that can be sold. These are difficult to use with an OTC stock.

³⁰ 17 CFR 240.144(e)(3)(vii). After the specified holding period, registration of restricted securities is not required when sold by persons who are not an issuer, underwriter, or dealer. See 15 USCA 77(d)(1). It is not beyond imagination that the SEC might contend that the transaction was not routine trading activity and, therefore, not eligible for the exemption. See Hicks, *Exempted Transactions Under the Securities Act of 1933*, SECEXTRANS § 1.01 (Treatise). Prof. Hicks suggests that

expire for non-affiliates.³¹ DF is not an affiliate even though he owns a sizable slug of CC stock. An affiliate is defined as someone who, directly or indirectly, controls or is controlled by the issuer by stock ownership, contract, or otherwise.³² This is the issue on which most lawyers and stock-

a sale of restricted securities by a non-affiliate might be argued by SEC to be a distribution and, therefore, not a routine trade, particularly if the non-affiliate had not held the stock for the one year period specified in Rule 144 (*17 CFR 230.144[d][1]*). See SEC No-Action Letters in *Harmony Trading Corp.* 1999 WL 1059812 (available December 20, 1999) and *Harry W. Falk*, 1974 WL 9366 (available April 10, 1974). The courts have been disinclined to accept the proposition that the exception is dependent upon a "routine trade." See *Ackerberg v. Johnson*, 892 F.2d 1328 (8th Cir. 1989); *Hedden v. Marinelli*, 796 F.Supp. 432 (N.D. Cal. 1992). Nevertheless, because the Supreme Court has said that the critical question in determining whether a distribution has occurred is whether the purchaser needs protection (*SEC v. Ralston Purina Co.*, 346 U.S. 199 [1953]), the SEC's argument is not frivolous.

³¹ 17 CFR 240.144(k)

³² The question of affiliate status is an important one. If that status exists it will impact many aspects of a securities transaction. The two most important are (1) the right of the affiliate to resell the stock, and (2) the care that must be exercised by the affiliate in making a sale. An affiliate is someone who, directly or indirectly through one or more intermediaries, controls or is controlled by the issuer of the stock. That status is determined at the time of resale. See Steinberg and Kempler, *The Application and Effectiveness of SEC Rule 144*, 49 *Ohio St. L. J.* 473, 479 (1988). Direct control may exist because of a large percentage ownership of stock or because of the position held with the company. Ranking officers and influential directors are generally thought to have direct control, as are family members holding a large percentage of shares viewed on a consolidated basis. The test for control is found in Rule 405 (*17 CFR 230.405*): Does the person have the power "to direct or cause the direction of the management and policy of a person, whether through the ownership of voting securities, by contract, or otherwise?" In 1972, the SEC recognized that the determination of control was fact dependent: "Status as an officer, director or 10 percent shareholder is but one fact which must be taken into consideration." *SEC No Action Letter, American-Standard*, 1972 WL 19682 (available Oct. 11, 1972). Many commentators have attempted to attribute guidelines to the agency. The most prevalent seems to be that 10 percent stock ownership raises a presumption of control. Frankly, that purported guideline is wrong and likely based on inadequate research or paranoia. The courts have found control not to exist where stock ownership was 38 percent (*WHN Investments v. Batzel*, 1995 WL 262248 [Del. Chan. 1995]); and 32 percent (*Woodward & Lothrop, Inc. v. Schnabel*, 593 F.Supp. 1385 [D.C. 1984]). Negative covenants regulating major corporate actions were inadequate to establish control in *Radol v. Thomas*, 556 F.Supp. 586 (S.D. Ohio 1983). The SEC has found 29 percent ownership by the Taft family not sufficient to establish control, given the limited interest of any particular family group, although family members served as officers and members of the board. (*SEC No Action Letter, Taft Broadcasting*, 1976 WL 11346 [available April 12, 1976]). The agency has also held that 15 percent ownership of an investment advisor by two of five trustees for a REIT was inadequate to establish affiliate relationship between the REIT and the advisor. Both were also directors of the advisor. *SEC No Action Letter, Property Securities of America*, 1974 WL 11035 (available June 17, 1974). There is clearly no presumption applicable to the determination of control. However, it is equally clear that any person claiming an exemption from registration will bear the burden of proof on the issue. *SEC No Action Letter, American-Standard*, 1972 WL 19628 (available Aug. 16, 1972). This case also scratches at the "controlling group" question as well as the sale of unrestricted stock by an affiliate (no holding period required). Since 1973, the SEC has usually refused to comment on the existence of control saying

that the issue is too fact dependent. *SEC No Action Letter, Johnson Products, Co., 1973 WL 8530* (available Sept. 28, 1973).

Other decisions by the SEC provide some light on a control decision.

(1) Persons owning up to 20 percent of a company's stock may now use the Short Form Schedule 13G (passive investor) as long as the person is not attempting to acquire or influence control. *Amendment to Beneficial Ownership Reporting Requirements, 1998 WL 7449, 66 SEC Docket 596* (Jan. 12, 1998).

(2) The SEC permitted amendment of the NYSE rules to require shareholder approval before issuance of new stock equal to 20 percent of the outstanding shares. Significantly, the action was predicated on the observation by the Exchange that "there was a widely-held belief that the ownership of 20 percent or more of the outstanding shares or voting power in a widely held company in most instances constitutes control." The SEC responded that "the Commission believes that retention of the policy's requirement for shareholder approval of actions resulting in a change of control" is appropriate. *Order Approving Proposed Rule Change Relating to Shareholder Approval Policy, 1989 WL 992033* (July 14, 1989). Because the companies listed on that Exchange are usually large with widely dispersed shareholders, it is reasonable to conclude that the same rationale would be doubly applicable to small companies with fewer shareholders. NASD Manual Rule 4350 sets 20 percent as the threshold for requiring shareholder approval for acquisitions by small cap companies listed on the Bulletin Boards. See Rule 4350(i)(1)(c)(ii)(a) and (b). The more general requirement does not specify a percentage. Rule 4350 (i)(1)(B).

(3) The SEC amended its own rules to define control of a small business Broker-Dealer at 25 percent stock ownership. *17 CFR 240.0-10. (63 FR 35508)* (June 30, 1998).

(4) The SEC's advisory committee recommended that 20 percent or 10 percent with a representative on the board of directors be established as the minimum percentage ownership that would incite inquiry into control. Kim, *From Disclosure to Registration*, 5 FEB Bus. L. Today 53 (1996).

(5) SEC has proposed 10 percent as the minimum percentage of stock ownership that would prompt inquiry into control. *Proposed Rules, 1997 WL 81862, 62 FR 9246* (Feb. 28, 1997).

(6) Long ago the SEC defined a 10 percent shareholder as an associate not an affiliate. *17 CFR 230.405*.

The courts have grappled a bit with the absence of a meaningful definition of "control" in the statute or regulations. Many courts have said that the meaning of "control" is determined by ordinary usage. In other words, "control" means control. See *United States v. Re, 336 F.2d 306* (2nd Cir.) *Re* is the seminal case. It has been cited extensively. E.g. *United States v. Wolfson, 405 F.2d 779* (2nd Cir. 1968). The absence of clear standards for proper conduct has caused one court to dismiss an SEC complaint. See *Checkosky v. SEC, 139 F.3d 221, 227* (D.C. Cir. 1998). Leaving definitional control to the Agency, particularly in criminal prosecutions, does seem inappropriate.

Interesting comments can be found in legal articles authored by accredited scholars: "Traditionally, the SEC has taken the view that the ownership of 20 percent ... of the voting power in a widely held company in most instances constitutes control." Coffee, *The SEC and the Institutional Investor: A Half-Time Report*, 15 Cardozo L. Rev. 837, 898 (1994). Coffee cites Exchange Act Release No. 27035 (July 18, 1989). Unfortunately, as shown in the release, it was the NYSE that traditionally took that view, not the SEC, although the SEC did approve the NYSE Rule using similar language. From the other end of the spectrum: "It is commonly understood that, for purposes of Rule 144, officers, directors, and 10-percent stockholders are deemed to exercise control and are therefore con-

brokers fumble the law. Sections 13 and 16 of the 34 Act (*15 USCA* §§ 78[m] and [p]) impose reporting requirements respectively on owners of five percent and 10 percent of a company's stock. These filing requirements are not applicable to CC because its stock is not registered under Section 12 of the 34 Act (*15 USCA* § 78[1]) and the OTC is not a National Securities Exchange.³³ Moreover these percentages relate to "insider" transactions and "takeover" activities. There is no suggestion that they purport to establish control. While the SEC has proposed a new rule that would set 10 percent ownership of a company as the minimum amount that would prompt an inquiry about control,³⁴ that Proposed Rule is opposed by numerous organizations³⁵ and it seems likely that the inquiry about control of or control by a "small business" will be set in the 25 percent range. After all, ownership of 10 percent of General Motors with its gillion shareholders is different than owning 10 percent of a much smaller entity.³⁶

4. Potential liability of CC and its transfer agent is addressed by the Uniform Commercial Code. The Texas version is part of the Business & Commerce Code. In general, a failure to transfer shares is a "conversion" unless the proposed transfer is not rightful.³⁷ In our factual example, the failure to accomplish the transfer was predicated on an alleged failure of consideration in the underlying contract for services. Such an allegation is not likely to protect CC and its transfer agent from DF's conversion claim.³⁸ Likewise the purchasers of the stock, because they acquired the stock for value

sidered to be affiliates." McPheters, *Option Open to Foreign Buyers for the Resale of Restricted US Securities*, 12-AUT Int'l L. Practicum 116, 120 (1999). McPheters should have said that it is commonly "misunderstood" The great state of Massachusetts did get it right, however: "10 percent is not a bright line either way." Stock Issue and Transfers, BLII MC-CLE 26-1 (1996).

There are many collateral issues that remain challenging to the securities lawyer. Foremost is the concept of "control group." How do you identify such a group? Who is part of the group? Is every member of the group in control? Do you use all sales by the group for aggregation purposes? A good place to start analysis is with the family group. See Hicks, *Relatives of Affiliates*, SECEXTRANS § 10:40 (treatise) (Feb. 2001).

³³ Application of both sections requires that the stock be registered under the 33 Act. *15 USCA* §§ 78 (m)(d) and (p)(a).

³⁴ *62 FR* 9246.

³⁵ The revisors suggested 20 percent as the minimum level for an inquiry to be prompted. The bankers have also urged a 20 percent threshold. Comments can be found at the SEC website under proposed rules.

³⁶ SEC has adopted 25 percent as the minimum ownership interest to prompt inquiry about control of a small business broker dealer. *17 CFR* 240.0-10, *63 FR* 35508-01. The courts have frequently alluded to the numerosity of shareholders in finding, for example, that 40 percent stock ownership constituted control. See *United Wolfson*, *465 F2d* 779, 781 (2nd Cir. 1968). In that case there were 5,000 or so shareholders.

³⁷ *Tx Bus. & Comm. Code* § 8.401. This provision also provides for damages if there is an unreasonable delay in the transfer.

³⁸ The issuance of stock for future services is not a valid transaction. *Tx Bus. Corp. Act*, Art. 2.16. Until 1993 our State Constitution contained a provision stating that a corporation could issue stock only for money paid or services already performed. *Tex. Const.*, Art. 12 § 6. That provision was repealed in 1993. The importance of this action by the voters will be self evident in the discussion of a corporation's duty to transfer share ownership. See Footnote 42, *infra*. Well, back to the point. The court in *McAlister v. Eclipse Oil Co.*, *98 SW 2d* 171 (*Tex.* 1936) dealt specifically with the issue whether a corporation may, after issuing fully paid and non-assessable shares, revoke those shares

without notice of any defect, would be "protected purchasers" and they too could have viable claims against CC and its transfer agent.³⁹ Obviously, DF's acquisition of the stock in exchange for services was a transaction not involving a public offering, and therefore the stock was "restricted."⁴⁰ CC's failure to note this restriction on the face of the stock certificates was a clear violation of the U.C.C.⁴¹ There is an interesting question whether the limitations imposed on the resale of restricted stock by federal law are implied and do not need to be printed on the stock certificate. So far a majority of courts have answered the question negatively.⁴²

based upon a claim of inadequacy of the consideration. The court held: "Under such a record we think that, as between each other, neither the corporation itself nor any of its shareholders has a right to say that the issuance of stock to McAlister was a void transaction in its incipiency." *Id. at 176*. In *Dysart v. Flemister*, 140 SW 2d 350 (Tex. Civ. App. - Dallas, 1940, writ ref'd.) the Dallas court likewise concluded that issued shares could not be revoked when it turned out that the consideration paid or received was worth less than it was thought. *Id. at 352-353*. This rationale has also been applied in a slightly different context. It has been held that the issuance of shares which state that they are "fully paid and non assessable" constitutes an enforceable covenant. *See Stasan, Inc. v. Logal*, 2001 WL 204778 (N.D. Tex. 2001). There, Judge Fish articulated that *McAlister, supra*, required such a result. His logic is compelling. If the corporate operatives have knowledge of the services performed to date and determine to issue shares, the shares will be conclusively deemed to have been validly issued based upon that consideration, in the absence of fraud. The importance of this conclusive determination cannot be overstated. In recent times numerous lawsuits have been filed seeking cancellation of shares and an injunction to prohibit the trading of those shares until the issue of cancellation is resolved. Judicial recognition of the validity of such a claim is contrary to the basic principles of commercial instruments law. The correct result is that the stock remains valid, and the corporation's damage claim is treated just like any other damage claim. In a similar vein, the failure to place a restrictive legend on shares of stock usually results in the corporation being estopped from contending that the shares are restricted. This estoppel even prevents the corporation from contending, in a lawsuit with the pledgee of a shareholder, that federal law imposes the restriction. *See Edina State Bank v. Mr. Steak, Inc.*, 487 F2d 640 (10th Cir. 1974). Indeed, the commercial laws of most states are patterned after the U.C.C. Section 8-204 of the Uniform Law which states that "Unless conspicuously noted on the security, a restriction on transfer imposed by the issuer even though otherwise lawful is ineffective except against a person with actual knowledge of it." The usual argument against this result is that the federal restriction is not imposed by the issuer. The usual answer is that the issuer does in fact impose the restriction by issuing the shares in an unregistered transaction instead of registering the shares with the SEC. *See* Footnote 42, *infra*.

³⁹ Tx Bus. & Comm. Code § 8.303. A protected purchaser is one who gives value, obtains control of the security, and has no knowledge of an adverse claim. Such a purchaser is not subject to any adverse claim.

⁴⁰ Rule 144 defines restricted stock as stock acquired directly or indirectly from the issuer or an affiliate of an issuer in a transaction or chain of transactions not involving a public offering. Also included in the definition is stock acquired in a 505, a 506, a 504 unregistered with an appropriate state, a 144A, a 701(c), a 901 or 903, an 801 or 802, and stock subject to the conditions of Regulation CE.

⁴¹ § 8.108 states the warranties made in a transfer of stock. One of those warranties is that there is no restriction on transfer.

⁴² The federal case law on this issue starts with the 10th Circuit's landmark decision in *Edina State Bank v. Mr. Steak, Inc.*, 487 F2d 640 (10th Cir. 1973). The court held that a failure to legend restricted stock rendered the issuer liable to a bank that took the stock as collateral for a loan in spite of the fact that federal law imposed restrictions on transfer. The applicable U.C.C. provision (§

5. CC's failure to register its initial public offering with the Texas agency did violate state law. A limited offering under Rule 504 is not exempt from state regulation.⁴³

6. The question of federal pre-emption was simplified in 1996 with adoption of the National Security Markets Improvement Act (NSMIA), *15 USCA § 77r*. Congress simply eliminated *any* state substantive involvement for "covered securities." This term includes (1) any security sold on the AMEX, NYSE, or NASDAQ National Market or on any exchange having the same or similar listing requirements, (2) any security issued by a company registered under the Investment Company Act of 1940 (mutual fund shares), (3) any security sold to a "qualified investor," as defined by the SEC (a definition of a qualified investor has recently been proposed, and it is the same as the definition of accredited investor--see footnote 6, *supra*), and (4) securities that are exempt from registration requirements under Sections 3 and 4 of the 33 Act (*15 USCA §§ 77[c]* and *[d]*), excepting Section 4(6), *15 USCA § 77d(6)*. So what's left for state supervision? Obviously not too much. Generally speaking, the state substantive umbrella can cover only non-bank and non-governmental securities issued under authority provided the Commission by Section 4(6), namely Regulation A (17 CFR 230.251-263) and/or Regulation D (17 CFR 230.501-508), excluding 506 (which implicates Section 4[2]), and/or intrastate sales under Section 3(a)(11) (*15 USCA 77c[a][11]*). Concern has been expressed that the SEC might supplant all state regulation by broadly defining exchange rules or by minimizing the level of sophistication required of a "qualified investor." In the case at hand the shares of CC were acquired by DF in a non-public transaction that would be exempt from most state requirements under Section 4(2) of the 33 Act, (*15 USCA §§ 77 d[2]*), if he was accredited, or Section 18(b)(3) (NSMIA), (*15 USCA § 77r [b][3]*), if he was "qualified." But unless CC can find a state exemption, it was necessary for it to comply with state registration and disclosure-content requirements in the original Regulation D offering. The result of this type of filing omission could be catastrophic. On the other hand, DF's sales were exempt from both state and federal registration requirements. His sales to friends and family would likely qualify for federal exemption under the ubiquitous Section 4(1 1/2) of the 33 Act⁴⁴ His public sales would find "safe harbor" under Rule 144, (*17 CFR § 230.144*). This is true because DF held the stock for more than a year and his sales

8.204) states "Unless conspicuously noted on the security, a restriction on transfer imposed by the issuer even if otherwise lawful is ineffective except against a person with actual knowledge of it." Mr. Steak argued that it did not impose the restriction, and therefore the provision was inapplicable. Not so, said the court. *Id. at 644*. This decision is better explained in later cases. The fact is that the issuer does "impose the restriction" when it decides to issue unregistered stock. *See Dean Witter Reynolds, Inc. v. Selectronics, Inc.*, 594 N.Y. S. 2d. 174 (S.C.A.D. 1993), and *DeWitt v. American Stock Transfer Co.*, 440 F.Supp. 1084, 1087 (S.D.N.Y. 1977). The Tenth Circuit relied on a Texas case from the *Dallas Court of Appeals. Prudential Petroleum Corp. v. Rauscher, Pierce & Co.*, 281 SW 2d 457 (Tex. Civ. App.--Dallas, 1955, ref'd n.r.e.). The federal restriction there involved the tradability of founders' shares. This raised substantially the same, if not exactly the same, issue that confronted the Tenth Circuit. The Texas Court, of course, resolved the issue in favor of the unsuspecting purchaser. *Id. At 459*. No review of this issue could be complete without mentioning *American Securities Transfer, Inc. v. Pantheon Industries, Inc.*, 871 F.Supp. 400 (D. Colo. 1994). There, the Colorado Constitution contained a provision that prohibited the issuance of shares except for consideration already received. Because the U.C.C. deems stock valid in the hands of an unknowing purchaser unless the prohibition is one contained in the state's constitution, the Colorado purchaser ended up holding an empty bag, so to speak. *Id. At 405-406*. As pointed out earlier, Texas removed a similar provision from its Constitution in 1993.

⁴³ See Footnote 6, *supra*.

⁴⁴ See Footnote 26, *supra*.

volume did not exceed the one-percent limitation. Under state law, DF's broker sales were exempt under Tx. Civ. Stat., Article 581-5c(1). While there is case law suggesting the existence of a broad private-sale exemption similar to Section 4(1 1/2) of the 33 Act, Texas does not have, as an available predicate, a provision generally exempting transactions by non-issuers/affiliates/underwriters.

7. Other interesting issues relate to DF's ability to sell the securities had he acquired them in a proper Rule 504 offering and the interplay between Section 4 of the 33 Act and the definition of an underwriter in Section 2(11) of that Act. On the first issue, the SEC has taken the position that even registered securities in the hands of an affiliate require compliance with the volume limitations in Rule 144.⁴⁵ On the latter issue it seems clear that DF, if an affiliate, must act with care in identifying a proper purchaser. If that purchaser does not have investment intent and intends to immediately commence public sales, he will be branded an underwriter and DF may well suffer the same fate because he was an important link in the distribution. Sales by an underwriter absolutely require registration.

If you are confused you are eligible to join a rather large club.

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Securities Law
Self-Regulating Entities
National Securities Exchanges
New York Stock Exchange

⁴⁵ See Steinberg and Kempler, *The Application and Effectiveness of SEC Rule 144*, 49 *Ohio St. L. J.* 473 (1988).