Recent Developments: SEC Relaxes Information Requirements for Resales of Restricted Securities under Rule 144

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SEC RELAXES INFORMATION REQUIREMENTS FOR RESALES OF RESTRICTED SECURITIES UNDER RULE 144

The Securities and Exchange Commission (SEC), which has broad powers to promulgate rules under the Securities Act of 1933 (Act), recently amended Rule 144 to allow resales of unregistered securities by *bona fide* investors. Securities Act Release No. 33-6488 (Sept. 23, 1983) *amending* 17 C.F.R. § 230.144(k) (1983). The "safe harbor" resale under Rule 144 is a means of reselling unregistered securities under the Act's exemption for non-underwriter transactions. Securities Act § 4(1), 15 U.S.C. § 77d(1) (1982). The Act requires that all securities transactions must be registered. Securities Act § 5, 15 U.S.C. § 77e (1982). However, certain securities and certain types of securities transactions are exempted from registration. One exemption applies to transactions by any person other than an issuer, underwriter or dealer. Securities Act § 4(1), 15 U.S.C. § 77d(1) (1982). Since most people are not issuers, underwriters or dealers, this exemption appears to be broad enough to allow ordinary people to resell securities without worrying about § 5 registration requirements. However, a close study of § 4(1) reveals that this conclusion is incorrect.

The Act's definition of "underwriter" includes many people who would not ordinarily consider themselves to be underwriters. An "underwriter" is defined as a person who:

> [1] has purchased from an issuer with a view to, or [2] offers or sells for an issuer in connection with, [3] the distribution of any security, or [4] participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but [5] such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual, and customary distributors' or sellers' commission. [6] As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

Securities Act § 2(11), 15 U.S.C. § 77b(11) (1982). The SEC has used the opaque language of this definition to regulate: (1) the *secondary distribution* of unregistered or "restricted" securities by their original purchasers, whomever they are; and (2) distributions of both restricted and non-restricted securities by control persons or "affiliates" of the issuer of the securities. The SEC regards "affiliates" as underwriters under § 2(11), thereby denying them the § 4(1) exemption and subjecting their transactions to the § 5 registration requirement. Securities Act § 2(11); Rule 144, 17 C.F.R. § 230.144(a)(1) (1983). A person reselling securities is not an underwriter, however, unless the resale qualifies as a "distribution." *Id.*

The term "distribution" is not defined in the Securities Act, but it has been the subject of administrative and judicial interpretations. There are two types of distributions: primary and secondary. A primary distribution is ordinarily a public offering in which securities are registered with the SEC and then sold to the general public through professional underwriters, brokers and dealers. The registration process ostensibly mandates disclosure of information material to the public's investing decisions. Theoretically, mandatory disclosure puts the public on an informational level with the corporate issuer and the seller.

Problems can arise, however, when the owner of restricted securities wants to resell them. This resale, known as "secondary distribution," presents two choices for the seller: (1) he may register the securities under the Act or (2) he may seek to qualify the resale under another transactional exemption. If, however, he is an affiliate of the issuer, he may be deemed to be an issuer or an underwriter (even if the securities are registered) and the resale may be deemed to be a "distribution" subject to SEC regulation. The affiliate seller, therefore, must find a safe manner of disposing of his securities and avoiding underwriter status, no matter what type of securities of the issuer he is selling.

Rule 144 defines *persons deemed not to be engaged in a distribution* for the purposes of qualifying for the § 4(1) non-underwriter exemption. Application of Rule 144 requires a two-step analysis: (1) is the person an affiliate or a non-affiliate?; and (2) are the securities restricted or non-restricted? If all of the conditions of Rule 144 are satisfied, the resale will not constitute a distribution, and the reseller will not be considered an underwriter under § 2(11) of the Act.

Rule 144 imposes various disclosure, holding periods, volume, manner of sales and notice requirements. Although the scope of Rule 144 is broad, certain key features can be noted. Resales by non-affiliates are regulated by Rule 144 only to the extent that the securities are restricted, as defined in 17 C.F.R. § 230.144 (a)(3)(1983). Rule 144 allows non-affiliates who have held securities for more than three years and have not been affiliates within three months prior to the sale to sell their securities without the notice, volume limits, or manner-of-sale limitations to which regular Rule 144 sales are subject. *Id.* § 230.144(k).

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DEBTORS' RIGHTS

The Court of Special Appeals of Maryland has clarified the "reasonable notification" a debtor must receive before a secured creditor can sell repossessed collateral to satisfy a debt. In *DiDomenico v. First National Bank of Maryland*, ____ Md. App. ____, 468 A.2d 1046 (1984), the court reversed a judgment in favor of First National Bank of Maryland in the amount of $7,523.89 plus $961.26 in attorneys' fees on the grounds that the bank's notice to the defaulting debtor failed to inform him that he had the right to redeem his property at any time up until the time the bank sold or otherwise disposed of it. MD. COM. LAW CODE ANN. (Maryland Uniform Commercial Code) § 9-504 (1975 & Supp. 1983). In so holding, the court relied on *Maryland National Bank v. Wathen*, 288 Md. 119, 414 A.2d 1261 (1980), in which the Court of Appeals of Maryland recognized the interrelation of §§ 9-504 and 9-506 of the

Maryland Uniform Commercial Code.

The controversy in *DiDomenico* arose out of the bank's suit against DiDomenico for a deficiency judgment to collect the unpaid balance due under the terms of a purchase money security agreement entered into by DiDomenico to finance the purchase of a mobile home. After being laid off, DiDomenico fell behind in his payments and authorized the bank to repossess the mobile home in which he was then residing. The notice of repossession, which DiDomenico received several days after being recalled to work, stated in pertinent part:

> You are entitled to redeem the said good provided that within fifteen days from the date of delivery of this notice you pay... $650.39 [the amount then due].... If you do not redeem as aforesaid, the goods will thereafter be sold at a private sale and if a deficiency arises, you will be liable.

Similar language appeared in an earlier notice of default received by DiDomenico. The earlier notice stated that in the event of repossession, "your right to this vehicle will be terminated fifteen days from the date... our notice of repossession is delivered to you...," but that "[p]rior to the expiration of the fifteen day interval, you may redeem the vehicle...." DiDomenico never redeemed the mobile home and the bank eventually sold it.

The notices which DiDomenico received gave him only fifteen days in which to redeem his property. Under § 9-506 of the Maryland Uniform Commercial Code, however, debtors have the right to redeem collateral "[a]t any time before the secured party has disposed of [it] or entered into a contract for its disposition... or before the obligation has been discharged...." Accordingly, DiDomenico argued that the notice of repossession was "unreasonable" because it was "misleading" and tended to discourage him from exercising his right to redeem his property before sale.

The court agreed and reversed the lower court's judgment, holding that the bank's notice was inadequate under § 9-504(3), which requires "reasonable notification" by the secured creditor to the defaulting debtor of the time and place of public sale or the time after which any private sale or other disposition of the collateral is to be made. Section 9-504(3), the court noted, must be read together with § 9-506, in keeping with the 1980 *Wathen* decision, in which the Court of Appeals of Maryland recognized the "interrelation" of the two provisions.

The bank defended its judgment on the grounds that its notice was sufficient under §§ 12-624 and 12-625 of the Maryland Uniform Commercial Code, also known as the Retail Installment Sales Act. The court was

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DISCOVERY ABUSE

Abuse of discovery procedures in the federal courts has resulted in changes to Federal Rule of Civil Procedure 26, which became effective on August 1, 1983. 69 A.B.A.J. 1640 (1983). A major revision to Rule 26 curtails repetitive discovery by deleting the provision permitting "unlimited use" of the various discovery methods. Fed. R. Civ. P. 26(b)(1). Judges can now limit discovery if it is determined that:

> (i) the discovery sought is unreasonable, cumulative or duplicative, or is obtainable from some other source that is more convenient, less burdensome, or less expensive;
> (ii) the party seeking discovery has had ample opportunity by discovery in the action to obtain information sought; or
> (iii) the discovery is unduly burdensome or expensive, taking into account the needs of the case, the amount in controversy, limitations on the parties' resources, and the importance of the issues at stake in the litigation....

Id.; 97 F.R.D. 213, 214 (1983).

This change was "designed to minimize redunancy in discovery and to encourage attorneys to be sensitive to the comparative costs of different methods of securing information." Fed. R. Civ. P. 26 advisory committee note. It will also aid judges in their attempts to stop the "games" played by the attorneys who can afford the paper, the word processors and the time to barrage opposing counsel with discovery.

Another change to Rule 26 is that every discovery request, response or objection must be signed by an attorney or by an unrepresented party. Fed. R. Civ. P. 26(g). The signature constitutes certification that the attorney has read the request, response or objection and that to the best of his knowledge, information and belief, formed after a reasonable inquiry, the request is:

> (1) consistent with these rules and warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law;
> (2) not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation; and
> (3) not unreasonable or unduly burdensome or expensive, given the needs of the case, the discovery already had in the case, the amount in controversy, and the importance of the issues at stake in the litigation.

Id.; 97 F.R.D. 213, 215 (1983).

The new certification requirement places a duty on the attorney or unrepresented party to make a reasonable inquiry into the appropriateness of the discovery request or response. In making the inquiry, "the attorney may rely on assertions by the client and on communications with other counsel in the case as long as that reliance is appropriate under the circumstances." Fed. R. Civ. P. 26 advisory committee note. The gist of the certification requirement is to require attorneys to stop and think about the legitimacy of a discovery request, response or objection. Fed. R. Civ. P. 26 advisory committee note. Amended Rule 26 encourages judicial participation in deterring discovery abuse and places a duty on attorneys to use caution in seeking discovery.

In Baltimore City, Judge Joseph I. Pines, discovery judge of the Circuit Court, has begun attaching one-page notices to his discovery orders. The notices state, "I am herewith advising counsel of my intention to vigorously exercise the options available to me to insure the proper use of discovery procedures in accordance with the dictates of the Maryland Rules of Procedure!" The Daily Record, Jan. 26, 1984, at 1, col. 1. Judge Pines' effort to deter discovery abuse in Baltimore's legal community is consistent with the policies expressed in the amended Federal Rule of Civil Procedure 26.

Discovery was designed to aid lawyers in simplifying litigation, not to create unnecessary delay and complications. This is the message being disseminated in the Federal courts and in Baltimore City.

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In the past, a non-affiliate could also resell restricted securities through Rule 237 of the Securities Act, 17 C.F.R. § 230.237 (1983), which provided an exemption and "safe-harbor" resale provision for any person other than the issuer, an affiliate, or a broker/dealer selling certain securities owned for more than five years. Rule 237 had volume restrictions, which were reduced by aggregations from other sales within one year, and required a notice filing. Rule 237, however, did not require that current information be available concerning the securities, as does Rule 144.

The resale limitations imposed on small business securities and "the current status of problems and programs relating to small business capital formation" prompted Congress in 1980 to direct the SEC to conduct an annual Government-Business Forum. Small Business Investment Incentive Act of 1980, Pub. L. No. 97-477 § 503(a), 94 Stat. 2275, 2292 (1980). At the first meeting, the participants felt that certain provisions of Rule 144 tended to deter investment in small business. In particular, the participants voiced their discontent with issuers' current information requirements, and recommended that Rule 144 be amended to allow non-affiliates to freely resell restricted securities after a holding period of three years. SEC Government/Business Forum on Small Business Capital Formation, *Final Report* at 53 (Nov. 1982).

In response, the SEC proposed in Securities Release No. 33-6472 (July 8, 1983) to revise Rule 144 by dropping the current information requirements and rescinding Rule 237 and Form 237. The SEC suggested that, since a nonaffiliate who has held restricted securities for three years would probably not have bought his securities from the issuer with a view toward distribution, he should not be considered an "underwriter." Thus, a rule requiring nonaffiliates to wait until information about the issuer is available or requiring the issuer to disseminate the information himself would be unduly burdensome. Accordingly, the SEC implemented the proposed Forum changes in Securities Act Release No. 33-6488 (September 23, 1983), effective October 31, 1983. The informational requirements were dropped from Rule 144, and the purpose of Rule 237 was subsumed in Rule 144, making Rule 237 unnecessary.

Rule 144, as amended, will benefit both non-affiliate investors and issuers of restricted securities by allowing secondary distributions of securities to be made more easily. Although the amended Rule may benefit capital formation and assist small business, the elimination of mandatory disclosure requirements may subvert the purposes of the Securities Act. Mandatory disclosure of material information helps the investor to make an informed decision. Under the amended Rule, an investor may purchase in a secondary distribution a restricted security that has been held for three years (and has not been held by an affiliate within the last three months), and about which no current public information may be available.

This change in Rule 144 amounts to failure by the SEC to enforce the mandatory disclosure requirements of the Securities Act. By amending Rule 144, the SEC has delegated the process of ensuring material disclosure in such secondary distributions to the states, which will have to ensure adequate disclosure through their blue sky laws if investors are to be provided with the information they need to make informed decisions. States, by and large, do not regulate secondary transactions, so one might argue that this SEC action fails to reflect the legislative intent underlying federal securities regulation, which is investor protection. *See* Seligman, *The Historical Need for a Mandatory Disclosure System*, 9 J. CORP. L. 1, 57-61 (1983).

One expert explains the SEC's partiality to small business as a mandate from the President and Congress and maintains that the SEC has a duty to assist capital formation. *See* R. Karmel, *Regulation by Prosecution* 281-89 (1982). Since the SEC's statutory mandate is protection of investors, not business, it seems the liberalization of Rule 144 is self-defeating.

It is unclear at this time whether more securities fraud will result from the relaxation of current information requirements in Rule 144. But deregulation is *de rigeur* these days, and the SEC is, because of its nature as an executive agency, politically influenced. A cost/benefit analysis is necessary to determine whether the benefits to small business from the deregulation of current information requirements outweigh the costs of fraud and deceit upon innocent investors.

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not persuaded, however, and found that since the bank was not the seller of the mobile home, its reliance on the Retail Installment Sales Act was misplaced. Accordingly, the court reversed the lower court's judgment in favor of the bank and remanded the case for further proceedings on DiDomenico's counterclaim for statutory damages brought under § 9-507(1) of the Maryland Uniform Commercial Code.

The bank has filed a petition for a writ of certiorari to have the case reviewed by the Court of Appeals of Maryland. Its petition is still pending.