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## — Business Law Group Client Alert —

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### CHANGES TO RULES 144 AND 145 SIMPLIFY RESALE OF RESTRICTED SECURITIES

As a general rule, selling a security is more difficult than buying. When an investor holds “restricted” securities or “control” securities, he or she must find an exemption from the Securities and Exchange Commission’s registration requirements to sell the securities in the public marketplace. Rules 144 and 145 under the Securities Act of 1933 provide a safe-harbor exemption from the SEC registration requirements to allow for the public resale of restricted and control securities, subject to the satisfaction of a number of conditions. Recently, the SEC adopted amendments to Rules 144 and 145 intended to increase the liquidity of restricted and control securities and ultimately decrease the cost of capital. These amendments:

- ♦ shorten the required holding period for resales of restricted securities of issuers required to file periodic reports with the SEC pursuant to Section 13 or 15(d) under the Securities Exchange Act of 1934 (referred to in this article as “reporting issuers”),
- ♦ reduce the burden of complying with Rule 144 for non-affiliate security holders of reporting issuers,
- ♦ exempt resales of debt securities from certain requirements of Rule 144, and
- ♦ codify several interpretations under Rule 144 that were previously only interpretive positions of the SEC’s Division of Corporation Finance.

#### WHAT ARE RESTRICTED AND CONTROL SECURITIES?

*Restricted securities* are securities acquired in unregistered, private sales from an issuer or from an affiliate of the issuer. Investors typically receive restricted securities through private placement financings including, Regulation D offerings, employee stock benefit plans as compensation for services, or in exchange for providing “seed money” or start-up capital to an issuer. Rule 144(a)(3) identifies the types of transactions that produce restricted securities. If the securities are acquired by non-affiliates through a securities exchange or over-the-counter market, they are not restricted.

#### BUSINESS LAW AT DAVIS MALM

Davis Malm business attorneys represent publicly traded and privately held businesses in a wide range of industries handling all areas of business and securities law, including initial organization, mergers and acquisitions, joint ventures, venture capital transactions, bank financings, restructurings, public offerings, private placements of equity and debt securities, and in day-to-day corporate matters. The group’s attorneys often act as outside general counsel for many of the firm’s clients, including those with in-house counsel. The group also counsels businesses regarding SEC requirements and represents venture capital and private equity firms in initial organization, investment, and buy-out transactions.

*Control securities* are commonly understood to be securities held by an “affiliate” of the issuer, regardless of how they were originally acquired. An affiliate is a person, such as a director or large shareholder, in a relationship of control with the issuer. Control means the power to direct the management and policies of the issuer in question, whether through the ownership of voting securities, by contract, or otherwise. If an investor purchases securities from a controlling person or “affiliate,” they take restricted securities, even if they were not restricted in the affiliate’s hands. Interestingly, the definition of control security is not found in Rule 144.

## RULE 144 – PRE-AMENDMENT

Before the amendments to Rule 144, security holders could resell restricted securities under Rule 144, subject to several conditions listed below, after holding their securities for one year. After two years, restricted securities could be sold without restriction so long as the security holder had not been an affiliate of the issuer for the three months prior to the sale.

- ♦ **Current Public Information.** There must be adequate current information about the issuer of the securities before the sale can be made. This generally means that the issuer has complied with the periodic reporting requirements of the Securities Exchange Act of 1934.
- ♦ **Volume Limitation.** The number of shares that may be sold during any three-month period cannot exceed the greater of one percent of the outstanding shares of the same class being sold and, if the class security is listed on a stock exchange or quoted on Nasdaq, one percent or the average reported weekly trading volume during the four weeks preceding the filing of a notice of the sale on Form 144. Over-the-counter stocks, including those quoted on the OTC Bulletin Board and the Pink Sheets, can only be sold using the one percent measurement.
- ♦ **Manner of Sale.** The sales must be handled in all respects as routine trading transactions, and brokers may not receive more than a normal commission. Neither the seller nor the broker can solicit orders to buy the securities.
- ♦ **Form 144.** Prior to or concurrent with the order placement, a notice on Form 144 must be filed with the SEC if the sale involves more than five hundred shares or the aggregate dollar amount is greater than \$10,000 in any three-month period. The sale must take place within three months of filing the form and, if the securities have not been sold, an amended notice must be filed.

## RULE 144 – POST AMENDMENT

- ♦ **Reporting Issuers: Non-Affiliates.** Under the amended rules, the Rule 144 holding period for non-affiliates has been reduced from one year to six months if the issuer has been subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act for 90 days prior to the sale. After that six-month holding period, a non-affiliate may engage in unlimited public resales so long as the issuer of the securities is current with its SEC reporting obligations. After a one-year holding period, non-affiliates may engage in unlimited public resales without complying with any other requirements of Rule 144, including the current public information requirement.
- ♦ **Non-Reporting Issuers: Non-Affiliates.** The amended rules provide for a one-year holding period for non-affiliates if the issuer is not subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act. However, after the one-year holding period expires, the selling security holder may engage in unlimited public resales without any conditions.
- ♦ **Reporting Issuers: Affiliates.** The revisions to Rule 144 shorten the holding period for affiliates from one year to six months if the issuer had been subject to the Section 13 or 15(d) reporting requirements of the Exchange Act for at least 90 days prior to the sale. After the six-month holding period, an affiliate may resell publicly so long as the other conditions of Rule 144 are satisfied, including: the current public information requirements; volume limitations; manner of sale requirements (equity securities only); and the filing of a Form 144, if applicable.
- ♦ **Non-Reporting Issuers: Affiliates.** There is a minimum one-year holding period for affiliates if the issuer is either not subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, or has not been subject to such reporting requirements for at least 90 days. After this one-year holding period, an affiliate may engage in resales that are conditioned upon the following requirements of Rule 144: the current public information requirements; volume limitations; manner of sale requirements (equity securities only); and the filing of a Form 144, if applicable.

The table on the following page provides a summary of the application of revised Rule 144 for public resales of securities of an issuer.

## CHANGES TO FORM 144

Under the amendments, the Form 144 filing threshold has

been raised. Prior to the changes to Rule 144, Rule 144(h) required a selling security holder to file a notice with the SEC on Form 144 if a security holder intended to sell more than either \$10,000 worth of securities or 500 shares within a three-month period. The SEC has amended Rule 144 to eliminate the need for non-affiliates to file a Form 144 notice and to increase the filing thresholds for affiliates to \$50,000 worth of securities or 5,000 shares within a three-month period.

## CODIFICATION OF DIVISION OF CORPORATION FINANCE PROVISIONS

The SEC also codified several interpretive positions that were previously issued by the staff of the Division of Corporation Finance, including the following:

- ♦ **Securities issued in certain limited offerings.** Securities issued under the exemption from registration under Section 4(6) of the Securities Act are considered to be restricted securities. Section 4(6) of the Securities Act exempts from registration transactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of the securities does not exceed \$5.0 million and there is no advertising or public solicitation in connection with the transaction.
- ♦ **Tacking of holding periods for holding company formations.** As amended, Rule 144 permits tacking of the holding period in connection with transactions solely to form a holding company if the following three conditions are satisfied:
  - (1) the newly formed holding company's securities are issued solely in exchange for the securities
- of the predecessor issuer as part of a reorganization of the predecessor company into a holding company structure,
- (2) security holders receive securities of the same class evidencing the same proportional interest in the holding company as they held in the predecessor issuer, and the rights and interests of the holders of such securities are substantially the same as those they possessed as holders of the predecessor issuer's securities, and
- (3) immediately following the transaction, the holding company has no significant assets other than securities of the predecessor and its existing subsidiaries and has substantially the same assets and liabilities on a consolidated basis as the predecessor had before the transaction.
- ♦ **Tacking of holding periods for conversions and exchanges of securities.** The Rule 144 amendments codify the position that if securities were acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities should be deemed acquired at the same time as the securities surrendered for conversion or exchange, even if the securities surrendered were not convertible or exchangeable by their terms.
- ♦ **Cashless exercise of options and warrants.** The amendments codify the position that upon a cashless exercise of options or warrants, the newly acquired underlying securities are deemed to have been acquired when the corresponding options or warrants were acquired, even if the options or warrants originally did not provide for cashless exercise by their terms.

	Affiliate or Person Selling on Behalf of an Affiliate	Non-Affiliate (and Has Not Been an Affiliate During the Prior Three Months)
<b>Restricted Securities of Reporting Issuers</b>	<u>During six-month holding period</u> – no resales under Rule 144 permitted. <u>After six-month holding period</u> – may resell accordance with all Rule 144 requirements including: <ul style="list-style-type: none"> <li>♦ current public information,</li> <li>♦ volume limitations,</li> <li>♦ manner of sale requirements for equity securities, and</li> <li>♦ filing of Form 144.</li> </ul>	<u>During six-month holding period</u> – no resales under Rule 144 permitted. <u>After six-month holding period but before one year</u> – unlimited public resales under Rule 144 except that the current public information requirement still applies. <u>After one-year holding period</u> – unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.
<b>Restricted Securities of Non- Reporting Issuers</b>	<u>During one-year holding period</u> – no resales under Rule 144 permitted. <u>After one-year holding period</u> – may resell accordance with all Rule 144 requirements including: <ul style="list-style-type: none"> <li>♦ current public information,</li> <li>♦ volume limitations,</li> <li>♦ manner of sale requirements for equity securities, and</li> <li>♦ filing of Form 144.</li> </ul>	<u>During one-year holding period</u> – no resales under Rule 144 permitted. <u>After one-year holding period</u> – unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.

The amendments also codify the position that if options or warrants are not purchased for cash or property and do not create any investment risk in the holder, such as employee stock options, the holder is not allowed to tack the holding period of the option or warrant and will be deemed to have acquired the underlying securities on the date the option or warrant was exercised, so long as the full purchase price or consideration was paid at the time of exercise.

- ♦ **Multiple pledgees: Calculation of volume limitations.** Sales of pledged securities held by multiple pledgees will not be aggregated for purposes of calculating Rule 144(e) volume limitations absent concerted action by the pledgees. However, pledgees must still aggregate sales with the pledgor when determining compliance with Rule 144(e) volume limitations.
- ♦ **Treatment of securities issued by reporting and non-reporting shell companies.** A person who wishes to resell securities that were issued by a company that is, or was, a reporting or a non-reporting shell company, other than a business shell company formed to acquire an operating business, may not rely on Rule 144 to sell the securities. However, the recent amendments to Rule 144 permit reliance on Rule 144 for resales by a security holder when:
  - (1) the issuer of the securities that was formerly a reporting or non-reporting shell company has ceased to be a shell company;
  - (2) the issuer of the securities is subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act;
  - (3) the issuer of the securities has filed all reports and material required to be filed during the preceding twelve months (or for such shorter period that the registrant was required to file such reports and materials); and
  - (4) at least one year has elapsed from the time the issuer filed current "Form 10 information" with the SEC, reflecting its status as an entity that is not a shell company.

## RULE 145 AMENDMENTS

Rule 145 provides that exchanges of securities in connec-

tion with reclassifications of securities, mergers, consolidations, or transfers of assets that require shareholder approval are in effect "sales" of those securities. Rule 145(c) holds that persons who were affiliates of the target company at the time of the vote on the transaction are deemed to be "underwriters" of these securities. Rule 145(d) subjects these affiliates to certain Rule 144 requirements.

The SEC has amended Rule 145(c) to remove this "presumptive underwriter" provision, except with respect to transactions involving a shell company. Rule 145(d) has been modified to conform to the amendments made to Rule 144 for the resale of securities of shell companies. As a result of these amendments, the provisions of Rule 145 are no longer applicable to the resale of securities received in connection with reclassifications of securities, mergers, consolidations or transfers of assets that are subject to shareholder vote, unless the issuer is a shell company.

The descriptions provided in this newsletter constitute a summary of the applicable regulations and are not a substitute for legal advice. If you have any questions, please contact one of the authors: Andrew D. Myers at (617) 589-3835 or [amyers@davismalm.com](mailto:amyers@davismalm.com) or Michael A. Troy at (617) 589-3884 or [mtroy@davismalm.com](mailto:mtroy@davismalm.com).

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