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SEC Proposes Amending Rule 144 and Rule 145 to Shorten the Holding Period Requirement for Affiliates and Non-affiliates

On June 22, 2007, the Securities and Exchange Commission ("SEC") proposed amending Rules 144 and 145 under the Securities Act of 1933 (the "Securities Act") to shorten the holding period required for restricted securities of reporting companies.[1] The proposed revisions are intended to increase the liquidity of privately sold securities and reduce companies' cost of capital without compromising investor protection. The SEC is seeking comments on the proposal by September 4, 2007. This memorandum contains a brief summary of Rule 144, Rule 145, and the proposed amendments thereto.

I. Rule 144 and the SEC's Proposed Amendments

A. Rule 144

Under Section 4(1) of the Securities Act, any person other than an issuer, underwriter or dealer is exempt from complying with the Act's requirement to register public offerings of securities. Rule 144 provides a safe harbor from the definition of "underwriter"— if a selling security holder satisfies all of Rule 144's conditions, he or she is deemed not to be an "underwriter" and is therefore exempt from the Securities Act's registration requirements.

B. Proposed Amendments to Rule 144

The SEC proposes various changes to Rule 144 that would shorten the holding period (and would modify other provisions of the Rule) which must be met by sellers desirous of availing themselves of the Rule 144 safe harbor. The SEC proposes to:

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[1] *Revisions to Rule 144 and Rule 145 to Shorten Holding Period for Affiliates and Non-affiliates*, SEC Release No. 33-8813; File No. S7-11-07 (June 22, 2007) available at http://www.sec.gov/rules/proposed/2007/33-8813.pdf. Restricted securities are securities acquired through one of the transactions enumerated in Rule 144(a)(3).

1. Shorten the holding period for restricted securities of publicly reporting companies

Rule 144(d) currently requires affiliates of an issuer and non-affiliates to hold restricted securities for at least one year prior to any public resale.[2] The proposed rule distinguishes between publicly reporting companies and non-reporting companies: it shortens the holding period from one year to six months for restricted securities of reporting companies, but maintains the current one year holding period for restricted securities of non-reporting companies. This change would apply equally to affiliates and non-affiliates holding such securities.

2. Suspend the holding period while security holders engage in certain hedging transactions

The proposed rule tolls, or suspends, the holding period for restricted securities of reporting companies while the security holder engages in certain hedging transactions. The SEC considers hedging activities, which shift the economic risk of investment away from the security holder, to be analogous to the sale of restricted securities before the holding period expires.

Rule 144 currently permits "tacking" of holding periods (counting the previous owner's ownership period towards the Rule 144 holding period so long as such owner was not an affiliate of the issuer), and the proposal would operate in conjunction with this tacking rule. The security holder may tack the previous owner's holding period onto his or her own only if the current security holder reasonably believes the previous owner did not engage in hedging activities.[3]

The proposed rule caps the holding period at one year, so that regardless of the security holder's hedging transactions, the holding period would not exceed that under the current rule.

3. Reduce the resale restrictions on non-affiliates

Under the current rule, both affiliates and non-affiliates must (1) hold their restricted securities for one year, and (2) comply with all applicable conditions of Rule 144 when selling securities that they have held between one and two years. The SEC's proposal suggests reducing the restrictions on non-affiliates in two respects:

- After the six-month holding period but before one year, non-affiliates holding restricted securities in reporting companies would only need to comply with Rule 144's requirement that current information regarding the issuer of the securities be publicly available, but would not need to comply with any of the other requirements.
- After holding the securities for over one year, non-affiliates (in both reporting and non-reporting companies) would be able to sell their restricted securities without restriction.

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[2] An "affiliate" is defined in Rule 144 as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, [the] issuer." Rule 144(a)(1).

[3] This aspect of the proposal reintroduces a tolling period mechanism which had been eliminated in changes to Rule 144 adopted in 1990. The proposed tolling provision would apply if a security holder sold a short position or entered into a "put equivalent position," as defined in Rule 16a-1(h) under the Securities Exchange Act of 1934, with respect to the restricted securities owned by such holder.

The SEC believes that holding the securities for the required period is a sufficient indication that non-affiliates have assumed the risk of investment and would therefore eliminate the present requirement that non-affiliates hold restricted securities for two years before being allowed to sell without complying with the other conditions of Rule 144.

4. Eliminate the manner of sale limitations with respect to non-equity securities

Currently, Rule 144(f) imposes manner of sale limitations that (1) require securities to be sold in brokers' transactions or in transactions with a market maker, (2) prohibit the seller from soliciting orders to buy securities in connection with Rule 144 transactions, and (3) prohibit the seller from making a payment in connection with the offer or sale of securities to persons other than the broker who executes the order to sell the securities. The proposed rule eliminates these manner of sale limitations for the resale of debt securities, non-participating preferred stock, and asset-backed securities, but retains these restrictions for equity securities. This proposal is intended to increase flexibility in the resale of these securities while continuing to require brokers to promote compliance with Rule 144 in the context of equity securities, an area where the elimination of the manner of sale limitations is more likely, in the view of the SEC, to result in abusive transactions.

5. Increase the Form 144 filing thresholds

Under Rule 144(h), a selling security holder must file Form 144 if the security holder's intended sale or sales exceeds either 500 shares or $10,000 within a three-month period. The SEC proposes to raise the Form 144 filing thresholds to trades of 1,000 shares or $50,000 within a three-month period for affiliates, and to eliminate the Form 144 filing requirement for non-affiliates.

6. Codify several staff positions

The SEC proposes to codify certain staff interpretations of Rule 144 in an attempt to simplify the rule. It proposes to:

- amend the definition of restricted securities to include securities acquired under Section 4(6) of the Securities Act;[4]
- permit "tacking," for the purpose of Rule 144(d)'s holding requirement, of the time period during which securities are held prior to a transaction which formed a holding company, provided certain conditions are met;
- deem securities acquired from the issuer in exchange for other securities of the same issuer to have been acquired at the same time as the securities surrendered for conversion or exchange, regardless of whether the securities surrendered were convertible or exchangeable by their terms;
- deem underlying securities acquired as a result of a cashless exercise of options or warrants to have been acquired when the corresponding options or warrants were acquired, regardless of whether those options or warrants provided for cashless exercise by their terms;

[4] Section 4(6) exempts from registration an offering that does not exceed $5,000,000 that is made only to accredited investors, that does not involve any advertising or public solicitation by the issuer or anyone acting on the issuer's behalf and for which a Form D has been filed.

- permit a pledgee of securities to sell the pledged securities without having to aggregate the sale with sales by other pledgees of the same securities from the same pledgor, as long as the pledgees are not the same "person" under Rule 144(a)(2) and there is no concerted action by those pledgees;
- make Rule 144 inapplicable to the resale of securities issued by "reporting and non-reporting shell companies" (though, once the reporting company has ceased to be a shell company, the proposed rule would allow the reseller to rely on Rule 144, provided certain conditions are met); and
- amend Form 144 to conform with Rule 10b5-1(c) under the Securities Exchange Act of 1934 such that a Form 144 filer who satisfies Rule 10b5-1(c) may indicate that he or she did not have knowledge of material non-public adverse information about the issuer as of the date of the written trading plans or instructions that satisfy Rule 10b5-1(c).

II. Rule 145 and the SEC's Proposed Amendments

A. Rule 145

Rule 145 provides that exchanges of securities in connection with reclassifications of securities, mergers, consolidations or transfers of assets that are subject to shareholder vote constitute sales of those securities and must, therefore, be registered under the Securities Act. Under the current rule's "presumptive underwriter provision," persons who are parties to these transactions, other than the issuer, and affiliates of such parties are deemed underwriters, and are therefore restricted in their ability to resell the securities they obtain through these transactions.

B. Proposed Amendments to Rule 145

The SEC proposes changes to Rule 145(c) and (d) that would:

- eliminate the parties' presumed underwriter status for Rule 145 transactions, except those transactions involving shell companies, in order to facilitate the resale of securities; and
- with respect to securities of shell companies, harmonize Rule 145's requirements with the proposed revisions to Rule 144, such that persons who are still deemed presumed underwriters under Rule 145 may resell their securities to the same extent as affiliates of a shell company reselling securities under Rule 144.

III. Coordination of Form 144 Filing Requirements with Form 4 Filing Requirements

Form 144 and Form 4 have overlapping reporting requirements, and some individuals are required to file both forms. The SEC is soliciting comment on how best to coordinate the two forms' filing requirements for affiliates who seek to rely on Rule 144 and are also insiders of the issuer who are required to file a Form 4. Specifically, the SEC is soliciting comments on whether it should:

- revise the filing deadline for Form 144 to coincide with the filing deadline for Form 4 (within two business following the date of a reportable transaction);
- permit affiliates to satisfy their Form 144 filing requirements by filing a Form 4 to report the sale of their securities (and, if so, which disclosure items should be transferred from Form 144 to Form 4); and

- revise Item 701 of Regulations S-B and S-K to require additional disclosure regarding the resale status of securities issued in unregistered transactions at the time the company first issues the securities.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at (212) 701-3100 or jmark@cahill.com; John Schuster at (212) 701-3323 or jschuster@cahill.com; or Yafit Cohn at (212) 701-3089 or ycohn@cahill.com.