

News from our Public Securities Group

SEC Approves Major Changes to Rule 144 and Rule 145

Overview

On November 15, 2007, the SEC approved significant amendments to Rule 144 and Rule 145 under the Securities Act of 1933 (the "Securities Act").¹ The key amendments:

- ▶ shorten to six months the Rule 144 restricted security holding period for affiliates and non-affiliates of an SEC reporting company, rather than one year under the existing rule;
- ▶ permit non-affiliates of an SEC-reporting company to resell restricted securities without regard to Rule 144 volume, reporting or manner of sale limitations after a period of six months;
- ▶ permit non-affiliates of an SEC-reporting company to resell restricted securities without regard to any Rule 144 requirements, including the current information requirement, after a period of one year;
- ▶ permit non-affiliates of non-reporting companies to freely resell securities after a one-year holding period, rather than two years under the existing rule;
- ▶ permit immediate resale of securities received in a business combination covered by Rule 145; and
- ▶ increase the Form 144 filing thresholds for affiliates.

Effective date

The amendments to Rule 144 and Rule 145 become effective on February 15, 2008 and the revised holding periods will apply

irrespective of whether the securities were acquired *before* or *after* the effective date.

Practical implications of the rule changes

The shortening of the holding period for non-affiliates to six months may have a positive impact on the value of securities sold in exempt transactions, as discounts attributable to resale restrictions should be reduced. The rule changes may also have a positive effect on private investments in public equity, or PIPE, transactions since PIPE investors now generally require the resale of these securities to be registered by the issuer with the SEC within a short period of time after the private placement closes. If an issuer fails to obtain effectiveness of the registration statement within the contracted period of time (and maintain its effectiveness), the issuer is generally subject to significant penalties. With the availability of shorter holding periods under Rule 144, these costly registration statements may be unnecessary or, at the very least, PIPE investors may no longer insist that such registration statements remain effective after six-twelve months (thereby reducing the risk of the issuer incurring penalties for failing to maintain an effective registration statement).

History of Rule 144

Section 4(1) of the Securities Act exempts transactions involving securities held by persons other than the issuer or an underwriter from the registration requirements of the Securities Act. Section 2(a)(11) of

the Securities Act defines an underwriter as a person purchasing securities from the issuer with a view to distribution. Rule 144 was adopted by the SEC to provide a non-exclusive safe harbor from this definition of "underwriter" to assist security holders in determining whether the Section 4(1) exemption was available for their resales. Rule 144 regulates two categories of securities—restricted securities and control securities. Restricted securities are securities acquired directly from the issuer

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or an affiliate of the issuer in a private placement. Control securities are securities held by an affiliate of the issuer, irrespective of whether the securities are restricted securities.

Rule 144 amendments

A brief discussion of the effects of the Rule 144 amendments follows.

A. Amendments to holding periods and selling conditions applicable to restricted securities

Non-affiliates holding restricted securities of a reporting issuer. Non-affiliates² may sell restricted securities in SEC-reporting companies³ without any restrictions other than the public information requirement⁴ if they have held their shares longer than six months. According to the SEC, a six-month holding period provides a “reasonable indication” that an investor has assumed the economic risk of his, her or its investment. The SEC stated that by reducing the holding period and streamlining the conditions applicable to sales by non-affiliates, the liquidity of privately sold securities should increase and the cost of capital for SEC reporting companies should decrease. If non-affiliates hold their shares longer than one year, the public information requirement is also eliminated.

Affiliates holding restricted securities of an SEC reporting company. Affiliates may sell restricted securities in SEC reporting companies with restrictions (current public information, volume limitations, manner of sale requirements and Form 144 filing) if they have held their shares longer than six months. While the Rule 144(f) manner of sale requirement has been retained, the SEC made two key changes which permit the resale of the securities through “riskless principal transactions” and allow brokers to post bid and ask quotations for those transactions in alternative trading systems. The manner of sale limitation with respect to debt securities, non-participating preferred stock and asset-backed securities was also

eliminated and an alternative method of computation of the volume limit for debt securities has been added—a limit equal to 10% of a particular series or tranche (or class in the case of non-participating preferred stock) in any three-month period. The size of sale thresholds for filing a Form 144 have increased from 500 shares or \$10,000 in the intended sale to 5,000 shares or \$50,000 in the intended sale.

Affiliates holding control securities of an SEC-reporting company. Affiliates may sell control securities in SEC-reporting companies with certain Rule 144 restrictions (public information, volume limitations, manner of sale requirements and Form 144 filing). Amended Rule 144 did not change this requirement.

Affiliates and non-affiliates holding restricted securities of a non-reporting issuer. The holding period applicable to restricted securities of non-reporting issuers remains unchanged at one year. After the one-year holding period, however, the non-affiliate may make unlimited public resales under Rule 144 without compliance with any other Rule 144 requirements whereas the affiliate may make public resales only in compliance with the Rule 144 requirements (public information, volume limitations, manner of sale requirements and Form 144 filing).

B. Codification of staff positions

The revisions to Rule 144 also codify numerous interpretative positions taken by the SEC staff.

Securities acquired under Section 4(6) of the Securities Act. Securities acquired from an issuer in an offering to accredited investors under Section 4(6) are “restricted securities” for purposes of Rule 144.

Cashless exercise of options or warrants. Restricted securities received upon a cashless exercise of either an option or a warrant may tack the holding period of the derivative security to the newly acquired securities, regardless of whether the original

terms of the option or warrant provided for a cashless exercise feature. Tacking is not permitted when the derivative securities are amended to allow for a cashless exercise and the holder delivered as consideration for the amendment something other than securities. Tacking is similarly not allowed when the options or warrants are not purchased for cash or property and do not create an investment risk to the holder, as is the case with employee stock options.

Tacking holding periods for companies reorganizing into holding company structure.

A holder of restricted securities is permitted to tack the holding period of the predecessor company’s securities as long as the holder received securities of the same class and rights, evidencing the same proportional interest, and immediately following the transaction, the holding company has substantially the same assets and liabilities on a consolidated basis as the predecessor company.

Tacking holding periods for conversions and exchanges.

Securities surrendered solely for other securities of the same issuer may tack the holding period of the restricted securities acquired from the issuer even when the securities were not convertible or exchangeable by their original terms. Tacking is not permitted when the surrendered securities are amended to allow for cashless exchange or conversion and the holder delivered as consideration for the amendment something other than securities.

Aggregation of pledged securities. Two or more pledgees of the same pledgor/security holder may sell pledged securities without the need to aggregate the sale with other sales of other pledgees of the same securities from the same pledgor so long as the pledgees are not the same person for Rule 144 purposes and are not acting in concert.

Shell companies. Rule 144 is unavailable for the resale of securities issued by a shell company (a company with no or nominal

operations and either no or nominal assets or assets consisting primarily of cash and cash equivalents). The rule will, however, be available to business combination-related companies (*i.e.*, a shell corporation formed to effect a business combination).

Form 144 representations. A security holder using a Rule 10b5-1 trading plan may make the Form 144 representation that it does not have any material non-public adverse information about the issuer as of the date of the adoption of the trading plan or delivery of trading instructions (rather than the date of the Form 144).

C. Conforming changes

In addition to the Rule 144 amendments, the SEC made a number of changes to other rules under the Securities Act to conform those rules to the amended Rule 144. Rule 903(b)(3)(iii) for Category 3 reporting issuers under Regulation S (the regulation governing securities transactions outside the U.S.) has been revised to reduce the distribution compliance period from one year to six months. Rule 701(g) (the regulation providing an exemption for the resale of certain shares acquired pursuant to equity incentive plans) has been revised to remove references to Rule 144(e) and Rule 144(h), since resales by non-affiliates are no longer restricted in this manner. Rule 190 has been revised to retain the two-year holding period for restricted securities issued in an asset-backed transaction.

D. Tolling provisions aimed at hedging not adopted

The SEC did not adopt a proposed amendment to Rule 144 that would have reintroduced tolling provisions applicable to Rule 144 holding periods in cases where a holder had engaged in certain hedging transactions (including short sales and put or other options). The SEC noted that it was concerned that the new, shorter holding periods could increase the use of these hedging arrangements since they become less costly as a result of the much shorter

time period. However, the SEC did not adopt the amendment due to a concern that the tolling rules could unduly complicate securities transactions and add significant cost as holders and brokers were required to monitor hedging activities for purposes of Rule 144. The SEC announced that it would revisit this issue if it perceives abuse relating to hedging activities among holders of restricted securities.

Rule 145 amendments

Rule 145 relates to exchanges of securities involving mergers, reclassifications, consolidations and transfers of assets, which are subject to a shareholder vote, and to the resale of securities received in those combinations. Prior to the recent amendments, Rule 145(c) deemed persons who were parties to such a transaction and their affiliates to be underwriters unless the resales complied with the requirements (*i.e.*, volume, manner of sale and other limitations of Rule 145(d)), commonly referred to as the presumptive underwriter provision. Under revised Rule 145, the presumptive underwriter provision was eliminated and securities held by these parties (*i.e.*, affiliates of the acquired company) are transferable without restrictions provided that they are not affiliates of the acquirer after the transaction. These affiliates will also be permitted to hedge their positions prior to the closing of the transaction. Securities held by affiliates of the acquirer will remain subject to Rule 144, other than the holding period requirement, due to the fact that such securities are control securities.

Transactions subject to Rule 145 (*i.e.*, mergers, reclassifications, consolidations and transfers of assets) effected pursuant to an exemption from registration (*e.g.*, a private placement) will result in the issuance of restricted securities and therefore may be resold only pursuant to an effective registration statement or an available exemption, such as Rule 144.

The presumptive underwriter provision will continue to apply to transactions involving shell companies other than business combination-related companies. ■

Notes

¹ The final Rule 144 and Rule 145 revisions are set forth in Rel. No. 33-8869, Revisions to Rules 144 and 145, *Final Rule* (Dec. 17, 2007), available at www.sec.gov/rules/final/2007/33-8869fr.pdf.

² The non-affiliate must have been a non-affiliate of the issuer for three months prior to the resale.

³ An SEC reporting company is an issuer that is subject to the reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act") for at least 90 days prior to the Rule 144 sale.

⁴ The public information requirement of Rule 144(c) generally requires that, for an SEC reporting company, it has been subject to the requirements of the Exchange Act for at least 90 days prior to the Rule 144 sale and has filed all required Exchange Act reports during the prior 12 months (or such shorter period as required) or that, if the issuer does not file reports with the SEC, it has made publicly available the information that would be necessary for a broker-dealer to publish a market quotation.