SEC Proposes Amendments to Rules 144 and 145

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On June 22, 2007, the U.S. Securities and Exchange Commission (the "Commission") published for comment significant changes to Rule 144 under the Securities Act of 1933 (the "Securities Act").[1] The proposed changes would, in particular, provide for relaxation of the safe harbor provisions of Rule 144 for sales of restricted securities. The Release also proposes generally to eliminate the "presumptive underwriter" provisions of Rule 145. The Commission approved the publication of these proposals for comment at its open meeting on May 23, 2007 as part of a package of proposals intended to facilitate public and private capital-raising activities and to ease disclosure requirements, in both cases particularly for smaller companies.

Rule 144 provides a safe harbor from the definition of "underwriter" to assist security holders in determining whether an exemption from the registration requirements of the Securities Act is available for the resale of securities. If a selling security holder satisfies all of Rule 144's applicable conditions in connection with a transaction, he or she is generally deemed not to be an "underwriter". The Commission has amended Rule 144 a number of times since it was first adopted in 1972, including most recently in 1997 when it shortened the holding periods to permit resales of restricted securities by both affiliates and non-affiliates after one year, subject to limitations, and by non-affiliates (who had not been affiliates during the prior three months) without restriction after two years. At that time, the Commission also proposed a number of other changes to Rule 144, some of which are revisited in the new proposals.

The principal change proposed by the Commission in the Release is to shorten the holding period under Rule 144 generally to permit sales of restricted securities after six months (or up to one year for securities that have been subject to hedging) in the case of issuers that are reporting companies with current information, and after one year in the case of other issuers, while at the same time substantially relaxing the other restrictions currently applicable to the resale of restricted securities by non-affiliates. The proposal would,

[1] SEC Release No. 33-8813 (June 22, 2007) (the "Release").

however, maintain the two-year holding period for certain purposes in respect of asset-backed securities backed by restricted securities. The Commission is also proposing to revise the rule's Preliminary Note, to eliminate manner of sale restrictions with respect to sales of debt securities by affiliates, to codify various staff interpretive positions relating to Rule 144 and to revise the Form 144 filing requirements. With respect to Rule 145, in addition to proposing to eliminate the presumptive underwriter provisions in most cases, the Release proposes to harmonize the restrictions of Rule 145(d) with those of proposed Rule 144 in those limited cases where Rule 145 would continue to apply.

The Commission is soliciting comments on its proposals. Comments on the proposals are due by September 4, 2007. The Commission's full release, including the text of the proposed amendments, is available at http://www.sec.gov/rules/proposed/2007/33-8813.pdf.

I. Amendments to Holding Period Requirement and Reduction of Requirements Applicable to Non-Affiliates

The Release proposes amendments to Rule 144 that would:

- shorten the Rule 144 holding period requirement for restricted securities of companies that are required to file reports under the Securities Exchange Act of 1934 (the "Exchange Act") (such companies, "reporting companies") to six months if the security has not been subject to certain hedging transactions;

- require security holders to suspend, or "toll", the holding period during times in which they (or prior holders) have entered into certain hedging transactions (subject to a maximum holding period of one year); and

- substantially reduce the restrictions on non-affiliates so that they could resell securities of reporting companies freely after the holding period (subject only to the continued availability of public information during a holding period of six months to one year).

A. Six-Month Holding Period for Reporting Companies

Under the proposed revisions to Rule 144(d), both affiliates and non-affiliates would be permitted to resell publicly restricted securities of reporting companies (which must have been reporting companies for at least 90 days before that resale) after holding those securities for six months, subject to any other applicable conditions of Rule 144, so long as they (and prior holders) have not engaged in hedging transactions with respect to those securities. The Commission indicated that this change is intended to increase the liquidity of

privately sold securities and to decrease the cost of capital for reporting companies, and that it believes that holding securities for six months is a reasonable indication that an investor has assumed the economic risk of investing in those securities.

For non-reporting companies (including companies that have been reporting companies for fewer than 90 days), the Commission has proposed a one-year holding period, as in the existing rule. However, as described in more detail below, in the Release the Commission proposes to eliminate the resale restrictions imposed on non-affiliates of non-reporting companies after that period, which should also increase the liquidity of those securities.

B. Tolling Provision Relating to Hedging Activities

At the same time that it is proposing to shorten the holding period for restricted securities, however, the Release suggests that the Commission remains focused on whether a purchaser of restricted securities has assumed the economic risk of the investment, and is thus focused on the effect of hedging transactions designed to shift the economic risk of investment away from the security holder. The Release notes that it is "more difficult to conclude that the security holder who engages in hedging transactions, and thereby transfers the economic risk of the investment to a third party, soon after acquiring the security, has held the security for investment purposes and not with a view to distribution."

To address this issue, the proposed revisions to Rule 144 include a provision that would toll the holding period for restricted securities of reporting companies up to a maximum of six months, providing a maximum holding period of up to one year, where a security holder (or prior holder), either an affiliate or a non-affiliate, has engaged in certain hedging transactions.[2] Under the new proposed rule, the tolling provision would apply to any period in which the security holder (or prior holder) had either a short position or had entered into a "put equivalent position"[3] with respect to (i) in the case of an equity security, any equity security of the same class or any security convertible into a security of such class

[2] A tolling provision was removed from then-existing Rule 144 in 1990. That provision tolled the holding period, without a maximum time limit, of a security holder to the extent the holder maintained a short position in, or any put or other option to dispose of, securities of the same class as the restricted securities owned by the security holder. The Release indicates that the Commission eliminated the tolling provision in connection with expanding the tacking provisions applicable to restricted securities and simplifying the holding period to create a single period running from the date of purchase from the issuer or its affiliate.

[3] Rule 16a-1(h) under the Exchange Act defines a "put equivalent position" as a derivative security position that increases in value as the value of the underlying equity decreases, including (but not limited to) a long put option and a short call option position.

and (ii) in the case of a nonconvertible debt security, with respect to any nonconvertible debt security of the same issuer.

Holders of restricted securities of non-reporting companies would not be subject to the tolling provision, as they would already have a one-year holding period requirement under the proposed rule.

The proposed amendments to Rule 144 in the Release would appear not to be intended to alter substantially the framework that market participants are currently using to analyze hedging transactions under Section 5 of the Securities Act. The proposal does address hedging involving convertible securities, but by the terms of the proposed rule, it appears that a holder of convertible securities might be able to enter into a hedging transaction in respect of the underlying security without tolling the holding period.[4]

The Release notes that, in connection with the tacking provisions applicable to Rule 144 transactions, a selling security holder would be required to determine whether a previous owner of the securities (if any) had engaged in hedging activities with respect to the securities. There would be no tolling with respect to a previous owner's holding period if the security holder for whose account the securities are to be sold "reasonably believes" that no short or put equivalent position was held by that previous owner. However, the Release also states (at note 69) that if a security holder is "unable to determine" that a previous owner did not engage in hedging activities with respect to the securities, then the security holder must omit the period for which it is unable to make that determination from the holding period.[5] The Release does not specify the means by which a purchaser could determine whether any belief he or she may have about the existence of past hedging should be characterized as reasonable.[6]

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[4] Under the proposed rules, the tolling provision also could apply in situations where security holders have hedged their exposure to convertible securities using credit default swaps. To the extent the credit protection buyer under a credit default swap could deliver the convertible security itself following the occurrence of a credit event trigger, the credit default swap would seem to involve hedging an equity security using a security of the same class, thus requiring tolling of the holding period.

[5] Again, however, the maximum holding period for securities of a reporting company would never be required to exceed one year.

[6] These standards may prove problematic to the extent that trading in privately placed securities, including those sold pursuant to Rule 144A, involves anonymous transactions or otherwise does not permit these types of determinations to be made. There may be some private offerings where prudence will argue in favor of a general one-year holding period as a result of hedging practices generally and difficulties in making such determinations.

The Release provides two means designed to assist in determining whether sellers who are affiliates of the issuer have met their holding period requirements under Rule 144. First, if the securities have been held for less than one year, then with respect to sales of equity securities in "broker's transactions" complying with the manner of sale requirements in Rule 144(f), brokers should ask the seller, as part of the reasonable inquiry required by Rule 144(g), about the nature of any short or put equivalent position relating to those securities, whether the seller has made similar inquiries of any previous owner of the securities and the results of any such inquiry.[7] Second, any Form 144 filed by an affiliate selling security holder with respect to sales of restricted securities will be required to disclose whether and for how long the holding period for such securities was tolled by virtue of a short or put equivalent position (similar to a requirement of Form 144 before the tolling provision was eliminated in 1990). For sales by non-affiliates, we would expect brokers and market makers similarly to expand their inquiries to determine whether the non-affiliate is eligible to resell freely securities that have been held for a period between six months and one year.

To the extent the Commission determines to reinstitute tolling, we believe several clarifications to the proposed rule would be desirable. The Commission could further clarify the means by which a purchaser can develop a reasonable belief as to the hedging activities of the seller (and previous holders). The Commission could also clarify that any hedging transaction entered into by the holder affects only the amount of securities hedged pursuant to that transaction (as was the case prior to 1990) and could provide guidance as to how tolling should be implemented in the case where only a portion of a security holder's position is hedged.

C. Elimination of Most Rule 144 Requirements Applicable to Non-Affiliates

The Commission proposes to eliminate most of the currently applicable restrictions on sales of restricted securities under Rule 144 for any person who is not an affiliate of the issuer at, and has not been an affiliate for three months prior to, the time of the sale. With respect to the securities of reporting companies, the proposal would permit non-affiliates to resell the securities they hold after the six-month holding period (or such longer period up to one year as may be required as a result of any hedging activity), subject only to the requirement of Rule 144(c) that current information regarding the reporting company be publicly available. After a one-year holding period (regardless of any hedging activities), non-affiliates would be permitted to resell freely securities of both reporting and non-reporting companies without having to comply with any other conditions.

[7] In the Release, the Commission indicated its belief that such an inquiry would not impose an undue burden on brokers as part of their existing inquiry.

The proposals would thus eliminate most of the requirements currently applicable to non-affiliate sellers with respect to resales of securities that have been held for between one and two years, including limitations on the amount of securities that can be sold in any three-month period, manner of sale limitations, Form 144 filing requirements and (after one year) the requirement that current information about the issuer be publicly available. Those limitations will, however, continue to apply to restricted securities held by an affiliate of the issuer (other than manner of sale limitations with respect to debt securities, which the Commission has proposed to eliminate as described below).

II. Other Proposed Changes To Rule 144

A. Simplification of the Preliminary Note to Rule 144

The Commission has proposed several "Plain English" changes to the Preliminary Note to Rule 144, which it has indicated are intended not to alter the substantive operation of the rule. In short, the proposed changes are intended to clarify that any person who sells restricted securities, and any affiliate or any person who sells restricted securities or other securities on behalf of an affiliate, will not be deemed to be engaged in a "distribution" of those securities, and thus will not be deemed an "underwriter" with respect to those securities, if the sale in question is made in accordance with the applicable provisions of Rule 144. The Preliminary Note would also clarify that, although Rule 144 provides a safe harbor for establishing the availability of the exemption provided by Section 4(1) of the Securities Act (*i.e.*, for transactions by any person other than an issuer, underwriter or dealer), it is not the exclusive means for reselling securities without registration.

Existing Rule 144 refers to Section 4(1) of the Securities Act, which provides an exemption from Section 5 of the Securities Act for persons other than issuers, underwriters and dealers, but does not refer to Section 4(3) of the Securities Act, which provides an exemption for dealers, including dealers no longer acting as underwriters. The proposals take the same approach. In the past, however, the staff has indicated by means of interpretive and no-action relief that broker-dealers acting for their own account may rely on Rule 144 when selling restricted securities.[8] Assuming the staff does not withdraw these

[8] See, e.g., *Bear, Stearns & Co.* (Mar. 6, 1986) (where a dealer purchased restricted shares for its own separate investment account while acting as a specialist in the issuer's common stock in the ordinary course of its business, and the staff took the position that the short position resulting from a dealer's activities as a market maker in the issuer's stock should not affect the holding period in the sale of restricted shares if all conditions of Rule 144 were met); *Precision Optics Corp., Inc.* (Jan. 14, 1993) (where the staff took the position that when an underwriter acquires "compensation securities" from an issuer in a transaction not involving a public offering, those securities are restricted securities within the meaning of Rule 144(a)(3) and, accordingly, "… Rule 144 would be available for resales of such Compensation Securities, provided all the conditions of the rule are satisfied."); *Insilco Corp.* (May 2, 1974) (where the staff took the position that Rule 144 would be available to a broker-dealer, which also acted as a specialist in an issuer's common stock, in connection with the sale of restricted

positions and otherwise makes no further pronouncement relating to the point, it would appear that dealers should be able to continue to rely on Rule 144. Nevertheless, since the Commission is revisiting Rule 144, it would be helpful if the Commission clarifies that dealers can rely on Rule 144 for sales pursuant to Section 4(3).

In addition, the Commission has proposed including a statement in the revised Preliminary Note that the Rule 144 safe harbor is not available with respect to any transaction or series of transactions that, although technically complying with the rule, is part of a plan or scheme to evade the registration requirements of the Securities Act. This is consistent with language contained in the original 1972 adopting release for Rule 144, which stated that Rule 144 would not be available with respect to any transaction by a seller that, although in technical compliance with its provisions, was part of a plan to distribute or redistribute securities to the public. The proposed language mirrors language included as part of subsequent safe harbors from the registration requirements of Section 5 of the Securities Act, including both Rule 144A and Regulation S.

B. Elimination of "Manner of Sale" Limitations with Respect to Debt Securities

The Release proposes to eliminate the existing manner of sale limitations contained in Rule 144(f) for resales of debt securities by affiliates.[9] (Manner of sale limitations would not apply in any event in the case of sales by non-affiliates.) Those limitations are intended to ensure that special selling efforts and distribution-like compensation arrangements are not present in a Rule 144 sale, and brokers and market makers have in effect been empowered to serve as gatekeepers to promote compliance with Rule 144. The Commission notes in the Release that, while it continues to have concerns that eliminating these restrictions for equity transactions might lead to abusive practices, it believes the fixed income market does not raise the same concerns. The proposal would also apply to non-participating preferred stock and asset-backed securities, based on what the Commission perceives as the characteristics of, and the nature of the purchasers of, those securities.

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shares held in its investment account if all of the conditions of Rule 144 were satisfied (including the condition that the shares be sold in "brokers' transactions") and that any short positions in the issuer's common stock it established in the normal course of its specialist business would not be deemed to affect the holding period for such restricted shares so long as the short positions did not have any other relationship to the shares held in the investment account).

9 Rule 144(f) currently requires that securities be sold in brokers' transactions or in transactions with a market maker, and prohibits a seller from either soliciting or arranging for the solicitation of orders to buy the securities in anticipation of, or in connection with, the Rule 144 transaction or making any payment to any person other than the broker executing the trade in connection with the offer or sale of the securities.

C. Codification of Certain Staff Positions Relating to Rule 144

The Commission has proposed to codify several staff positions previously issued by the Division of Corporation Finance regarding Rule 144, in order to simplify the rule by making these staff positions more transparent and readily available to the public.

1. Holding Periods for Conversions and Exchanges of Securities

The Commission has proposed codifying the staff's position that, if securities are acquired from an issuer in exchange for other securities of the same issuer – for example, securities issued pursuant to Section 3(a)(9) of the Securities Act – the newly acquired securities will be deemed to have been 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. In addition, the Release includes a note that clarifies that if (i) the original securities do not permit cashless conversion or exercise by their terms, (ii) the issuer amends the original securities to allow for cashless conversion or exercise and (iii) the security holder provides consideration for that amendment other than securities of the issuer, then the new securities will be deemed to have been acquired on the date the original securities were so amended.

2. Holding Periods for Cashless Exercise of Options and Warrants

The Commission has proposed codifying the staff's position that, upon a cashless exercise of options or warrants, the newly acquired underlying securities will be deemed to have been acquired when the corresponding options or warrants were acquired, even if the options or warrants did not originally provide for cashless exercise by their terms. As with convertible and exchangeable securities, if the terms of the options or warrants are amended to permit cashless exercise and in connection with that amendment the holders provide consideration other than securities of the issuer, then the securities received on cashless exercise of those options or warrants will be deemed to have been acquired on the date the original options or warrants were so amended.

The Commission has also proposed to codify the staff's position that grants of certain options or warrants that were not purchased for cash or property (including, in particular, employee stock options) do not create any investment risk, and accordingly, the holder of those securities is not permitted to tack the holding period of the option or warrant to that of the security delivered upon exercise, and would instead generally be deemed to have acquired the underlying securities on the date the option or warrant is exercised.

3. Modification of Form 144 Representation For Sale Under Rule 10b5-1(c)

The Commission has proposed codifying the staff's position that a selling security holder who sells securities pursuant to and satisfies Rule 10b5-1(c) may modify the representation in Form 144 to indicate that he or she had no knowledge of material adverse information about the issuer as of the date on which he or she adopted the written trading plan or gave the trading instruction pursuant to the plan, specifying that date and indicating that the representation speaks as of that date, rather than requiring such representation to be as of the date the form is signed (as is currently required by Form 144).

4. Codification of Other Interpretations

The Commission has also proposed to codify a number of other staff positions, which include that:

- securities acquired from an issuer pursuant to the exemption from registration under Section 4(6) of the Securities Act are "restricted securities";[10]

- a pledgee of securities may sell the pledged securities without having to aggregate the sales by other pledgees of the same securities from the same pledgor, so long as the pledgees are not the same person for purposes of Rule 144(a)(2) and there is no concerted action by the pledgees;

- holders may tack the Rule 144 holding period in connection with transactions that are conducted solely to form a holding company, subject to certain requirements; and

- Rule 144 is not available for the resale of securities issued by shell companies (as defined in Rule 405 under the Securities Act), other than business combination shell companies, until at least 90 days after the company ceases to be a shell company and files a Form 10 to that effect with the Commission.

III. Revisions to Form 144

The Release proposes three significant changes to Form 144. First, as noted above, non-affiliate sellers would no longer be required to file Form 144. Second, the proposed changes to the rule would increase the filing threshold for affiliates to trades of 1,000 shares

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

or $50,000 within a three-month period.[11] Third, with respect to securities held for less than a year, an affiliate seller using Form 144 would be required to disclose any hedging activities that it had entered into in connection with those securities.

IV. Application of Rule 144 to Asset-Backed Securities Transactions

The Release also proposes changes to Rule 190 under the Securities Act, which addresses when registration of the sale of underlying securities is required for transactions involving asset-backed securities. One of the current requirements to avoid registration pursuant to Rule 190 is that the depositor could freely resell the securities without registration under the Securities Act, including sales by non-affiliates pursuant to Rule 144(k). The Release notes that the proposed changes to Rule 144 would potentially permit the resecuritization of privately placed debt or other asset-backed securities in as little as six months after issuance. The Commission, however, believes that this would be inappropriate, based on the particular circumstances of asset-backed securities and the established experience with a two-year holding period. Accordingly, the Release proposes to amend Rule 190 to provide that, if the underlying securities are Rule 144 restricted securities, Rule 144 must be available for the sale of the securities in the resecuritization and at least two years must have elapsed since the later of the date the securities were acquired from the issuer of the underlying securities or an affiliate of the issuer. Absent this two-year holding period, the underlying securities would need to be concurrently registered with the offering of the asset-backed securities to which they relate.

V. Amendments to Rule 145

The Release proposes to eliminate the presumptive underwriter provision of Rule 145, other than with respect to transactions involving securities of shell companies (other than business combination shell companies). Rule 145 currently provides that exchanges of securities in connection with reclassifications, mergers, consolidations or transfers of assets subject to shareholder vote constitute sales of those securities, deems parties to such transactions (other than the issuer) and their affiliates to be underwriters, and sets forth restrictions on the resale of securities received in such transactions. For transactions involving shell companies, the proposed rule would harmonize the resale requirements of Rule 145(d) to correspond to the proposed provisions of Rule 144.

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[11] The Commission is also soliciting comment on how best to coordinate the filing of Form 144 with the filing deadline for Form 4 and whether to permit affiliates subject to Section 16 reporting requirements, at their option, to satisfy the Form 144 filing requirement by timely filing a Form 4.

Questions regarding the Commission's proposals can be directed to your regular contacts at the firm or to any of our partners and counsel listed under Securities and Capital Markets in the "Our Practice" section of our web site, at http://www.clearygottlieb.com.

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