Sales Of Legended Securities -- Is Rule 144 Your Answer?

Your client is contemplating the acquisition of securities in an "off-market" unregistered exempt securities transaction and wants your advice concerning the potential liquidity of this investment. Your client owns "legended" securities that prevent their transfer except pursuant to a Securities and Exchange Commission ("SEC") registration statement, an exemption from these registration requirements, or an opinion of counsel acceptable to counsel for the Issuer of the securities. SEC Rule 144 may very likely provide you with the "roadmap" for advising your client in these situations.

BACKGROUND

The fundamental concept of the Securities Act of 1933 (the "1933 Act"), as implemented by the SEC, is to assist investors and prevent fraud in the offer and sale of securities by requiring disclosure to prospective investors of all material information relevant to informed investment decisions concerning the purchase of securities. This concept has caused the SEC and the federal courts to require parties to certain securities transactions to use transfer restraints and to establish the scope and duration of these restraints in the resale of securities. The resale restraints may apply because of either the nature of the person attempting to resell (e.g. an "affiliate/control person" of the issuer) or the nature of the transaction where the holder acquired the securities. Resale restrictions may include the following:

(1) Holding Period. The owner of the securities may be prohibited from reselling for a prescribed period of time;

(2) Availability of Information. The ability to resell in the public securities markets may depend on whether the issuer has made publicly available specified disclosures that are required under the Federal securities laws;

(3) Volume. A quantitative limitation may be imposed to restrict the amount of securities that may be resold within a specified time period; and

(4) Manner of Sale. A prospective seller may be required to sell in ordinary securities market transactions or be limited to privately negotiated arrangements.

GENERAL DISCUSSION

Section 5 of the 1933 Act is designed to protect prospective purchasers of securities by requiring the filing of a registration statement, including a prospectus, that is reviewed by the SEC for purposes of correcting apparent disclosure deficiencies in the document before the securities may be sold to the public pursuant to the terms and conditions of the registration statement. However, these registration obligations are not intended to include all securities transactions. Accordingly, relief from these obligations has been granted through exemptions set forth in Sections 3 and 4 of the 1933 Act that relate to specific securities or securities transactions where Congress did not believe that registration was needed or appropriate for the protection of investors.

The 1933 Act thus reflects a distinction between two very different types of securities transactions. At one end is Section 5 which is intended to protect the investing public through the SEC registration process in situations where a full-scale public distribution of a substantial amount of securities is being attempted either directly by the issuer or through an underwriting agreement with an investment banker(s) that is implemented by the retention of a select group of broker-dealers who solicit the sale of the securities to their clients. In these situations, the pressures of solicitations, recommendations and other sales activities relating to the securities offering can cause inadvisable investment decisions that are made without accurate information relating to the issuer, its business and management, and the investment risks of the investment proposal. At the other end, is the routine sale of a few securities by a person who has no control over the issuer of the securities that are being sold. This type of ordinary securities trading

transaction does not present the promotional pressures inherent in a public securities offering and, therefore, should not subject the seller to the registration obligations of Section 5. While the preceding distinction between the "distribution" of securities and the "trading" in securities is not precise, it is nonetheless very helpful in explaining the interrelationship of relevant sections of the 1933 Act as described below and the presence of other 1933 Act transactional exemptions.

Without any qualifying provisions in the 1933 Act, the language of Section 5 would govern all securities transactions by "any person". Accordingly, Section 4(1) of the 1933 Act was designed to distinguish the distribution of securities and the trading in securities by removing the application of the registration requirements of Section 5 from any securities transaction "by any person other than an issuer, underwriter, or dealer." As the reasons for the registration requirements of the 1933 Act in the public sale of securities by the issuer of the securities have already been discussed and are self-evident, I have focused the remainder of this discussion on understanding the term "underwriter", as this term is fundamental to not only Section 4(1) but also the rationale and application of SEC Rule 144 discussed below.

Section 2(a)(11) of the 1933 Act defines the term "underwriter" as follows:

"The term underwriter means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security . . . 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."

As is apparent from the above statutory definition, determining whether someone is an "underwriter" in the sale of securities to the public is made by evaluating whether the person purchased the securities with a view to their distribution. Under this standard, individual investors who are not professionals in the securities business may be "underwriters" if they act as conduits in a chain of transactions through which securities move from an issuer to the public. Prior to the SEC's adoption of Rule 144, a determination of whether someone was an underwriter was extremely difficult because it required an evaluation of the mental state of the purchaser at the time of the acquisition of the securities. Lawyers would apply to the staff of the SEC for interpretations that their clients were not underwriters based on emphasizing such factors as the length of time the securities had been owned and on unforseeable changes in circumstances of the holder of the securities. Evaluation of these factual arguments by the SEC was necessarily subjective; did not assure adequate protection of investors through the maintenance of informed trading markets; and led to uncertainty in the application of the registration requirements of the 1933 Act. In view of these problems, the SEC adopted Rule 144 to provide certainty in evaluating the circumstances where the public resale of securities by affiliates of the issuer and the public resale of restricted securities could be effected without violation of the registration requirements of the 1933 Act. By complying with the requirements of Rule 144, the seller of the securities would not be considered an underwriter and, accordingly, the exemptive provisions of Section 4(1) of the 1933 Act would be applicable.

RULE 144 DISCUSSION

1. Overall Criteria of Rule.

In adopting Rule 144, the SEC indicated that: "The rule is designed to prohibit the creation of public markets in securities of issuers concerning which adequate current information is not available to the public. At the same time, where adequate current information concerning the issuer is available . . . the rule permits the public sale in ordinary trading transactions of limited amounts of securities owned by persons controlling, controlled by or under common control with the issuer [i.e., affiliates] and by persons who have acquired restricted securities of the issuer." Under this construction of Rule 144, it is the position of the SEC that affiliates may only resell non-exempt securities in public securities transactions (including securities that are not restricted under Rule 144) pursuant to either Rule 144 or an effective SEC Registration Statement.

The SEC in its adopting release also indicated that "In determining when a person is deemed not to be engaged in a distribution [i.e., not an underwriter] several factors must be considered.

First, the purpose and underlying policy of the 1933 Act to protect investors requires that there be adequate current information concerning the issuer, whether the resales of securities by persons result in a distribution or are effected in a trading transaction. Accordingly, the availability of the rule is conditioned on the existence of adequate current public information.

Secondly, a holding period prior to resale is essential, among other reasons, to assure that those persons who buy under a claim of an exemption have assumed the economic risk of investment, and therefore are not acting as conduits for sale to the public of unregistered securities, directly or indirectly, on behalf of an issuer. . . .

A third factor, which must be considered in determining what is deemed not to constitute a distribution, is the impact of the particular transaction or transactions on the trading markets. Section 4(1) was intended to exempt only routine trading transactions between individual investors with respect to securities already issued and not to exempt distributions by issuers or acts of other individuals who engage in steps necessary to such distributions. Therefore, a person reselling securities under Section 4(1) . . . must sell the securities in such limited quantities and in such a manner as not to disrupt the trading markets. The larger the amount of securities involved, the more likely it is that such resales may involve methods of offering and amounts of compensation usually associated with a distribution rather than routine trading transactions. . . ."

2. <u>Restricted Securities</u>.

Restricted securities absent a registration statement, may only be resold in the public securities markets pursuant to the requirements of Rule 144. For purposes of Rule 144, restricted securities include:

(a) Securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving a public offering. Accordingly, securities acquired pursuant to Section 4(2) of the 1933 Act in "transactions by an issuer not involving any public offering" are restricted securities.

(b) Securities acquired from the issuer in transactions exempt from the registration requirements of the 1933 Act pursuant to Rules 504, 505 or 506 of Regulation D. Prior to April 7, 1999, securities acquired pursuant to Rule 504 were not restricted securities subject to the requirements of Rule 144. The SEC, however, amended Rule 504, effective April 7, 1999, to make securities sold under Rule 504 restricted securities, unless the offer and sale of the securities under Rule 504 are made:

(i) Exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions;

(ii) In one or more states that have no provision for the registration of the securities or the public filing or delivery of a disclosure document before sale, if the securities have been registered in at least one state that provides for such registration, public filing and delivery before sale, offers and sales are made in that state in accordance with such provisions, and the disclosure document is delivered before sale to all purchasers (including those in the states that have no such procedure); or

(iii) Exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to "accredited investors" as defined in Rule 501(a) of Regulation D.

(c) Securities acquired from the issuer that are subject to the resale limitations of Rule 701(c). Rule 701 provides an issuer with an exemption from the registration requirements of the 1933 Act for the offer and sale, pursuant to the requirements of the Rule, to employees, officers, directors, consultants and advisors of the issuer, of securities issued pursuant to a written "Compensatory Benefit Plan" of the issuer. A Compensatory Benefit Plan is defined under the rule to include any purchase, savings, option, bonus,

stock appreciation, profit sharing, thrift, incentive, deferral compensation, pension or similar plan. If the issuer of the Compensatory Benefit Plan becomes subject to the reporting requirements of the Securities Exchange Act of 1934 ("1934 Act"), securities issued under the Rule may be resold by persons who are not affiliates, starting ninety days after the issuer becomes subject to the 1934 Act reporting requirements, without compliance with the current public information, holding period, volume limitation and SEC notice requirements of Rule 144 discussed below. For affiliates of the issuer such securities may be resold under Rule 144 without compliance with the holding period requirement of the Rule.

(d) Equity securities of domestic issuers acquired in a transaction or chain of transactions subject to the requirements of Regulation S. Regulation S is a set of SEC rules relating to the applicability of the registration requirements of the 1933 Act to the offer and sale of securities outside the United States . Prior to amendment of Regulation S in 1998, there were certain circumstances under which equity securities of a domestic issuer sold in reliance on Regulation S could be resold in U.S. securities markets after 40 days from the sale of the securities.

3. <u>Conditions of Rule 144</u>.

Rule 144 indicates that any seller of securities subject to the requirements of the Rule will be deemed not to be engaged in a distribution of such securities and therefore not an underwriter of such securities within the meaning of Section 2(11) of the 1933 Act if all of the following conditions of the Rule are met:

(a) Current Public Information

There must be available adequate current public information with respect to the issuer of the securities. Such information will be deemed to be available only if either of the following conditions is met:

(i) Filing of Reports

The issuer has been subject to the reporting requirements of the 1934 Act for a period of at least 90 days immediately preceding the sale of the securities and has filed all reports required to be filed during the 12 months preceding the sale (or for such shorter period that the issuer was required to file such reports). The seller may rely on a statement in the most recent issuer report, quarterly or annual, or in a written statement from the issuer, that it is in compliance with these reporting requirements.

(b) Other Public Information

If the issuer is not subject to the reporting requirements of the 1934 Act, there must be publicly available information concerning the issuer as set forth in specific provisions of SEC Rule 15c2-11. This latter rule is intended to ensure that broker-dealers have certain minimal information concerning the securities of companies for which they enter quotations for the purchase or sale of their securities.

(c) Holding Period for Restricted Securities

If the securities are not restricted within the meaning of Rule 144 and the seller is not an affiliate, the securities may be resold in the public securities markets without regard to Rule 144. If the seller is an affiliate but the securities are not restricted, the affiliate must comply with Rule 144, exclusive of the holding period requirements of the Rule. Accordingly, the following discussion is only applicable if the securities are restricted.

The general requirement of Rule 144 is that a minimum of one year must elapse between the later of the date of the acquisition of the securities from the issuer or from an affiliate of the issuer, and any resale of the securities. If the acquiror purchases the securities, the one-year period will not begin until the full purchase price or other consideration is paid or given by the person acquiring the securities. It is important to note that under these requirements, if the restricted securities have not been acquired directly from the issuer, the holding period under Rule 144 will depend on whether the seller was an affiliate of the issuer. In such event, the one year holding period will start, as discussed above, upon the acquisition of the securities. However, if the seller is not an affiliate, the acquiror may include the period

during which his seller was at economic risk as a result of his ownership of the restricted securities, in calculating the Rule 144 holding period.

In the event the acquiror gives a promissory note or other obligation to pay the purchase price or enters into an installment purchase contract, he will not be deemed to have made a full payment of the purchase price (i.e., the one year holding period will not commence) unless the promissory note, obligation or contract:

(i) provides for full recourse against the purchaser of the securities;

(ii) is secured by collateral, other than the securities purchased, having a fair market value at least equal to the purchase price of the securities; and

(iii) has been discharged by payment in full prior to the sale of the securities.

In light of the preceding requirements of the Rule, it has been the position of the SEC that the holding period for stock options does not begin until the stock options are exercised. However, as discussed above, there is a limited exception to this requirement with respect to options issued pursuant to Rule 701. Normally, however, the exercise of stock options that have been granted otherwise than pursuant to an effective SEC Registration Statement, will result in a minimum holding period of one year before the stock may be resold under Rule 144.

With respect to the calculation of the Rule 144 holding period, the Rule provides the following standards:

(i) *Stock Dividends, Splits and Recapitalizations.* Securities acquired from the issuer as a dividend or pursuant to a stock split, reverse split or recapitalization are deemed to have been acquired at the same time as the securities on which the dividend is paid, the securities involved in the split or reverse split, or the securities surrendered in connection with the recapitaliation.

(ii) *Conversions.* If the securities sold have been acquired from the issuer for a consideration consisting solely of other securities of the same issuer surrendered for conversion, the securities so acquired are deemed to have been acquired at the same time as the securities surrendered for conversion.

(iii) *Contingent Issuance of Securities.* Securities acquired as a contingent payment of the purchase price of an equity interest in a business, or the assets of a business, sold to the issuer or an affiliate of the issuer are deemed to have been acquired at the time of the sale if the issuer or affiliate was then committed to issue the securities subject only to conditions other than the payment of further consideration for the securities. Note the Rule specifically indicates that agreements to remain in the employment of, or not to compete with, the issuer or affiliate or the rendering of services are not deemed to be the payment of further consideration for the securities.

(iv) *Pledged Securities.* Securities that are pledged by an affiliate of the issuer when sold by the pledgee, or by a purchaser, after a default, are deemed to have been acquired when they were acquired by the pledgor, except that if the securities were pledged without recourse they are deemed to have been acquired by the pledgee at the time of the pledge or by the purchaser at the time of the purchase.

(v) *Gifts of Securities.* Securities acquired from an affiliate of the issuer by gift are deemed to have been acquired by the donee when they were acquired by the donor.

(vi) *Trusts.* If a trust settlor is an affiliate of the issuer, securities acquired from the settlor by the trust, or acquired from the trust by its beneficiaries, are deemed to have been acquired when the securities were acquired by the settlor.

(vii) *Estates.* If the deceased person was an affiliate of the issuer, securities held by the estate or acquired from the estate by its beneficiaries are deemed to have been acquired when they were acquired by the deceased person, except that no holding period is required if the estate is not an affiliate of the issuer or if the securities are sold by a beneficiary of the estate who is not an affiliate. While there is no

holding period or amount limitation for estates and beneficiaries that are not affiliates, the current public information and notice provisions of the Rule discussed herein apply to sales relying on the Rule.

(d) Limitation on Amount of Securities Sold

The amount of securities sold, together with all sales of other securities of the same class for the account of the seller in reliance upon the Rule within the preceding three months may not exceed the greater of (i) one percent of the issuer's outstanding shares as shown by the most recent report or statement published by the issuer, or (ii) the average weekly reported trading volume in the securities on all national securities exchanges and/or NASDAQ during the four calendar weeks preceding the filing of the seller's Rule 144 Notice with the SEC, or if no such notice is required, the date of receipt of the order to execute the securities transaction.

For purposes of calculating the volume limitations of Rule 144, the following "aggregation" rules should be considered:

(i) Where convertible securities and securities of the class into which they are convertible are sold, the amount of convertible securities sold will be deemed to be the amount of securities of the class into which they are convertible for the purpose of determining the aggregate amount of securities of both classes sold;

(ii) When securities are sold both by the pledgor and pledgee, or the account of a purchaser of the pledged securities, within a three month period, the sales of each must be aggregated to determine compliance with the volume limitations of Rule 144. The same aggregation rules apply to sales by a donor and donee, a trust and its settlor and an estate of a deceased person (or the account of a beneficiary of the estate) and the deceased person prior to his death. In addition, if two or more persons agree to act in concert for the purposes of selling securities of an issuer, all securities of the same class sold for the account of such persons during any period of three months must be aggregated for purposes of complying with the volume restrictions;

(iii) The following sales of securities need not be included in determining the amount of securities sold in reliance on the Rule: (1) securities sold pursuant to an effective registration; (2) securities sold pursuant to the Regulation A exemption under the 1933 Act; (3) securities sold in a transaction exempt pursuant to Section 4 of the 1933 Act and not involving a public offering; and (4) securities sold offshore pursuant to Regulation S.

(e) Manner of Sale

The Rule requires that Rule 144 sales must be made in brokers transactions or in transactions directly with a market maker. The purpose of this provision, along with the volume limitations of the Rule, is to ensure that only routine trading transactions between individual investors in regard to securities already issued is protected under the Rule and not to exempt distributions by issuers or acts of other individuals who engage in steps necessary to such distributions.

(f) Filing of Rule 144 Notice

If the amount of securities to be sold in reliance upon the Rule during any period of three months exceeds 500 shares or has an aggregate sales price in excess of $10,000, a Rule 144 notice is required to be filed with the SEC and any national securities exchange where the issuer's securities are admitted for trading. This notice must be transmitted for filing concurrently with either the placing with a broker of the sales order or the execution directly with a market maker of the sale.

(g) Termination of Rule 144 Restrictions

Absent an effective SEC Registration Statement, an affiliate of an issuer must rely on Rule 144 or another securities exemption for any resale of securities. However, the Rule specifically provides in subparagraph (k) that if the seller is not an affiliate of the issuer and has not been an affiliate for the preceding three months, he may sell his restricted securities without complying with the current public information, volume

limitation, manner of sale and notice requirements of the Rule, provided at least two years has elapsed since the later of the date the securities were acquired from the issuer or from an affiliate of the issuer. The effect of Rule 144(k) is thus to eliminate the substantive requirements of the Rule for non-affiliates after the securities are owned for the minimum two year period. As a result of the provisions of subparagraph (k), it is normal practice to have the issuer remove any restrictive legends after the two year period so that the securities may be resold in normal market transactions without regard to the requirements of Rule 144.

CONCLUSION

The provisions of Rule 144 are complex and very technical in nature. The application of the Rule can be confusing and difficult to evaluate in many situations. Accordingly, the professional representation of sellers in transactions involving the application of Rule 144 should only be exercised by persons familiar with the requirements and regulatory purpose of the Rule.