

## **SEC AMENDS RULE 144 (AND MORE)**

### **Good News for Self-Filers, PIPE Investors, Reporting Start-Ups and even Shells**

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#### **Long-Awaited Revisions Finally Here**

Following proposed changes in July 2007 and a flurry of subsequent formal comments, the Securities and Exchange Commission issued a release on December 6, 2007 detailing amendments to Rule 144 and Rule 145 (although the release also addresses important related issues). One of the SEC's primary objectives in adopting these amendments was to facilitate capital formation. In large part, the SEC accomplished this and several of its other objectives.

Thinking through my experiences in past shell transactions, reverse mergers and other going public alternatives, I have to say there are certainly some revisions that could be expanded further. Don't get me wrong though – there are plenty of reasons to be pleased with this release as is. In addition to shortened holding periods for Rule 144 stock, there are advances for shareholders of companies that are or used to be shell companies as well as companies that may fit the technical definition of "shell company" but are, in fact, bona fide small operating companies.

Some of the most significant changes are summarized below but bear in mind that the release is well over 100 pages long (and references hundreds of pages of related releases and commentary). Many of the changes are subtle and a full understanding requires a broader knowledge of securities law beyond what is written in the release. (Translated: Keep your securities attorney on speed dial when venturing into these areas, especially where anyone else's cash might be on the line.)

#### **Concepts and Terms**

A quick review of some concepts and terms will be helpful.

Restricted Securities. Generally, if you acquire securities that are not registered with the SEC, they are deemed restricted securities and you must find an exemption from the SEC's registration requirements to sell them in the marketplace. Restricted securities are securities acquired in unregistered, private sales from the issuer or from an affiliate of the issuer. Investors typically receive restricted securities through private placement offerings, Regulation D offerings, as compensation for professional services or in exchange for providing "seed money" or start-up capital to a company.

Control Securities. If you acquire control securities, you must also find an exemption from the SEC's registration requirements to sell them in the marketplace, even if those securities are registered, since they are deemed restricted for other reasons (e.g. stock held by those presumed

to have insider knowledge has restrictions). Control securities are those held by an affiliate of the issuing company. 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 company in question, whether through the ownership of voting securities, by contract, or otherwise. If you buy securities from a controlling person or affiliate, you take restricted securities.

Section 4(1) and the Underwriter Presumption. Section 4(1) of the Securities Act of 1933 (the “Securities Act”) provides that the registration requirements of the Securities Act “shall not apply to transactions by any person other than an issuer, underwriter, or dealer.” 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. If you receive newly-issued securities directly from the issuer (or an affiliate), or receive securities as a result of a business combination or similar transaction, you would likely fall under the SEC’s broad definition of an underwriter if you attempted to sell shares into the market without registration. (Even individual investors may be deemed to be “underwriters” within the meaning of the statute if they act as links in a chain of transactions through which securities move from an issuer to the public.)

Rule 144 Safe Harbor. Given the difficulty of proving that you are not a statutory underwriter, the SEC created Rule 144. Rule 144 provides a “safe harbor” for the resale of restricted and control securities because if you hold the securities for the period of time required by Rule 144, and satisfy a number of other conditions of the rule, the SEC will presume that you do not fall within the definition of an underwriter under the statute. If so, you are permitted to sell the securities publicly without registration. The SEC amendments recently made it much easier to comply with those conditions.

## **Amendments to Rule 144**

For both affiliates and non-affiliates, the Rule 144 amendments significantly shorten the holding periods applicable to resales of securities and lessen or reduce other requirements of Rule 144 as well.

Affiliates. If you are an affiliate of a reporting company, you may resell restricted securities after a six-month holding period (previously one year), subject to the public information, volume, manner of sale and Form 144 filing requirements. These requirements apply as long as you remain an affiliate. The time period increases by six months if the company is non-reporting.

Non-Affiliates. If you are a non-affiliate of a reporting company, you may resell restricted securities after a six-month holding period, subject only to the public information requirement. If the company is non-reporting, no sales are permitted for 12 months. After holding restricted securities of both reporting and non-reporting companies for 12 months, non-affiliates may resell their securities without restriction.

The SEC's revised holding periods and resale restrictions are summarized in the following chart:

	<b>Affiliate or Person Selling on Behalf of an Affiliate</b>	<b>Non-Affiliate (and Has Not Been an Affiliate During the Prior Three Months)</b>
<b>Restricted Securities of Reporting Issuers</b>	<p><b>During six-month holding period:</b> no resales under Rule 144 permitted.</p> <p><b>After six-month holding period:</b> may resell in accordance with all Rule 144 requirements, including:</p> <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>	<p><b>During six-month holding period:</b> no resales under Rule 144 permitted.</p> <p><b>After six-month holding period but before one year:</b> unlimited public resales under Rule 144 except that the current public information requirement still applies.</p> <p><b>After one-year holding period:</b> unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.</p>
<b>Restricted Securities of Non-Reporting Issuers</b>	<p><b>During one-year holding period:</b> no resales under Rule 144 permitted.</p> <p><b>After one-year holding period:</b> may resell in accordance with all Rule 144 requirements, including:</p> <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>	<p><b>During one-year holding period:</b> no resales under Rule 144 permitted.</p> <p><b>After one-year holding period:</b> unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.</p>

In addition, the amendments changed additional parts of Rule 144 and raised the thresholds that trigger the requirement to file Form 144 to trades of 5,000 shares or \$50,000 within a three-month period for affiliates. Of course, restrictive legends on stock certificates will still have to be removed to enable trading and issuer placement agents will likely continue to demand opinions of counsel acceptable to the company that all Rule 144 requirements have been met before they remove the legends.

## **Amendments to Rule 145**

Rule 145 of the Securities Act provides that exchanges of securities in connection with business combination transactions subject to shareholder approval constitute sales of those securities, which must be registered under the Securities Act. Prior to the current amendments, shares received by certain shareholders of an acquired company in a stock-for-stock transaction were subject to resale restrictions because they were presumed to be statutory underwriters. The Rule 145 amendments eliminate the "presumptive underwriter" doctrine with regard to these business combination transactions except with regard to transactions involving blank-check or shell companies.

## Other Significant Changes

Shell Companies / Reverse Mergers. The past seven years have required some extra work and creativity for entrepreneurs and attorneys structuring transactions with newly-formed and trading shells. On January 21, 2000, Richard Wulff of the SEC wrote a letter in response to an earlier letter from Ken Worm of the NASD (now known as the “Worm-Wulff letters”) advising that Rule 144 was not available for the resale of securities initially issued by companies that are, or previously were, “blank check” companies (defined by the SEC as “a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company...” The SEC didn’t actually define the term “shell company” until later).

Remember the “presumed underwriter” issue discussed earlier in this article? It was the SEC’s view that “transactions in blank check company securities by their promoter or affiliates....are not the kind of ordinary trading transactions between individual investors of securities already issued that Section 4(1) [of the Securities Act] was designed to exempt.” Given that analysis, the SEC stated that “both before and after the [reverse merger], the promoters or affiliates of blank check companies, as well as their transferees, are “underwriters” of the securities issued. Accordingly, we are also of the view that the securities involved can only be resold through registration under the Securities Act.”

Therefore, the safe harbor exemption of Rule 144 was not available, even if there was technical compliance with the rule, because the resale transactions appeared to be “designed to distribute or redistribute securities to the public without compliance with the registration requirements of the Securities Act.” This has generally been the prevailing law since 2000 – no resales of shares issued in connection with a reverse merger have been permitted without registration of the shares (as opposed to registration of the company) with the SEC. This became applicable to all holders of restricted and non-restricted shares of trading shells and non-trading shells, regardless of whether they were reporting or non-reporting.

With its December 2007 release, the SEC has reversed its “registration or hold” policy with respect to shell transactions and has opened a window for purchasers of shell securities. Upon the February 15, 2008 effective date of the release, a security holder may resell securities subject to the Rule 144 if the following conditions are met:

- a) The issuer of securities that was formerly a reporting or non-reporting shell company has ceased to be a shell;
- b) The issuer of the securities is subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act;
- c) The issuer of the securities has filed all reports and material required to be filed under Section 13 or 15(d) of the Exchange Act, as applicable, during the preceding 12 months (or for such shorter period that the issuer was required to file such reports and materials), other than Form 8-K reports; and
- d) At least one year has elapsed from the time the issuer filed current Form 10 type information with the SEC reflecting its status as an entity that is not a shell company.

While many of us in the industry had hoped that we would also see a six-month holding period applied to these transactions as well, there is still reason to be pleased. Rule 144 is now available for the resale of restricted and non-restricted securities that were initially issued by (i) a reporting or non-reporting shell company or affiliate; or (ii) an issuer that has been at any time previously a reporting or non-reporting shell company or affiliate. Be aware, however, that numerous subtleties exist and your factual situation is often not as clear cut as you would like. Issues regarding shares

of companies that had been legitimate public companies but later became shells, late filings during the one-year period, when the clock starts ticking, and other twists are subjects for another article. In fact, one of the most important “twists” facing shareholders of a company that has ever been a shell company involves the cancellation of share certificates bearing restrictive legends and the issuance by the transfer agent of new share certificates from share certificates. The process has become significantly more complicated for transfer agents, and attorneys who must give Rule 144 opinions, due to a variety of issues raised by the new rule and holders of shares of former shells may find that, while their shares may finally qualify under Rule 144, the holders might not be able to obtain non-legend share certificates.

PIPE Financing. Investment through a PIPE transaction (private investment in public equity) in a company that originated as a merger with a public shell faced the same prohibitions resulting from the Worm-Wulff letters. The securities had to be registered before they could be traded so detailed “registration rights” agreements were required as part of the transaction.

Registration agreements are typically accompanied by harsh penalties such as liquidated damages to make sure the company performed on its promises to register the PIPE investor’s securities for resale. In addition, because of the initial restrictions on share registration and concerns regarding what percentage of shares would be permitted by the SEC given certain other SEC rules and factors, shells often needed to accept the investment at a significant discount to value in the case of a trading shell.

While PIPE investors will continue to insist on registration rights agreements and other protections, the current amendments will generally provide earlier liquidity for PIPE investments in companies that have not been shells. With respect to investment in companies that were shells, there is at least the chance of some liquidity assuming the company has met the SEC requirements over the past year and it continues to remain current so long as the PIPE investor owns shares.

Self-Registrations. The BIG winners with regard to these recent amendments are companies planning a self-filing (when a company registers directly with the SEC). In a self-filing, not only does the company become a publicly reporting, but the company also registers shares of its recent investors, management or its other private shareholders, unlike a the filing involved with a reverse shell merger.

Since the self-filing company was never a shell company, it benefits greatly from the new Rule 144 holding period. Holders of shares that were not registered by the company in the initial round will be able to request that the restrictive legends on their share certificates be removed after only six months. Assuming the company is current in its SEC information reporting filings and that there is not another restriction on trading (e.g. insiders are subject to certain restrictions), the holders generally will be able to sell their shares on the open market after their six month holding period. Be sure to engage an experienced securities attorney to strategize with you regarding the best structure and timetable to accomplish your self-filing.

Start-Up Companies. For a number of years, companies in the start-up or development stages that want to be publicly-registered for valid purposes (e.g. to be in a position to attract financing needed to accomplish their business plan) have faced a significant SEC problem. There is a risk of being categorized as a “Footnote 32 shell” (so dubbed because of a footnote in SEC rulemaking related to reverse mergers in 2005). In Footnote 32, the SEC refers to transactions where the company filing with the SEC is actually not a legitimate business, or where it is a legitimate business with only nominal assets. In either case, the intent of the promoters or affiliates is to find a private company with which to merge with a new business resulting. In Footnote 32 scenarios, however,

none of this is disclosed to the SEC, thereby avoiding the characterization of the company as a shell and the numerous restrictions on shells.

Start-up companies have faced the risk of being characterized as a shell because of their limited operations or nominal assets. With the recent December 2007 release, however, the SEC indicated (interestingly in another footnote) that "Rule 144(i)(1)(i) is not intended to capture a "startup company," or, in other words, a company with a limited operating history, in the definition of a reporting or non-reporting shell company, as we believe that such a company does not meet the condition of having "no or nominal operations." Therefore, in the event a company is a legitimate business and that business continues into the future, the new six-month holding period should apply. (Warning however: Footnote 32 is very much alive at the SEC with regard to shell companies that are masquerading as start-ups but never hire employees or even open bank accounts - in actuality, they often use the company's cash to pay salaries and search for public shell companies with which to merge. Even a company that has ceased being a shell and has been trading for some time has significant risk if at some point in the past it was a Footnote 32 shell.)

## Conclusion

For the most part, the SEC has taken significant steps to facilitate a company's capital formation needs. Companies that work experienced securities counsel to self-file with the SEC are the big winners this time. Because of the recent amendments, they can now offer potential investors faster liquidity and improved information in most circumstances. Generally the amendments to Rule 144 should make capital raising and stock-for-stock acquisitions easier and less costly. Further, the revised holding periods and other amendments that have been adopted are "retroactive," meaning that they are applicable to securities acquired before or after the effective date of February 15, 2008.

Regardless of the new amendments, however, continue to bear in mind that SEC rules are not available with respect to any transaction or series of transactions that, although in technical compliance, is part of a plan or scheme to evade the registration provisions of the Securities Act. In such cases, registration under the Act is required. The final release is available at <http://www.sec.gov/rules/final/2007/33-8869.pdf>. Many other issues are addressed in the release. Perhaps I will deal with some of them in a future article. Be sure to send me an e-mail and let me know if this article was helpful to you or if you have other questions before continuing further in your own ventures.

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