The U.S. Securities and Exchange Commission (the “SEC”) changed when restricted and control securities can be sold in the public market. The SEC amended Rule 144, which provides a safe harbor from registration under the Securities Act of 1933, as amended, for sales of restricted and control securities.1 The SEC made other changes, including revising Rule 145 and conforming Regulation S. The amendments became effective February 15, 2008 and are applicable to securities acquired before and after the effective date.

The revisions:

- Shorten the initial holding period for restricted securities of reporting issuers (other than “shell” companies) from one year to six months.
- For non-convertible debt securities, eliminate the manner of sale requirement and increase the volume limitations.
- Free non-affiliates from all Rule 144 requirements after one year (six months for reporting issuers with current public information). Rule 144(k) required a two-year holding period before non-affiliates could sell freely.
- Eliminate the presumptive underwriter provision from Rule 145 (other than for transactions involving shell companies).
- Maintain traditional “dribble-out” limitations for the sale of equity securities for affiliates of the issuer after any initial holding period.
- Reduce the distribution compliance period under Regulation S for Category 3 U.S. reporting issuers from one year to six months.

The SEC indicated that the revisions were approved substantially as they were originally proposed.2 One significant exception is that the SEC did not adopt a proposed tolling provision that would have extended the holding period while security holders engaged in hedging activities. The purpose of this publication is to provide an overview of the changes to Rule 144 and other rules. Persons interested in further details or legal advice should contact their relationship partner or any of the Shearman & Sterling attorneys listed at the end of this client publication.

---

I. Rule 144

A. Overview

Rule 144 provides a safe harbor from registration for sales of restricted securities and control securities. Restricted securities are securities acquired directly or indirectly from the issuer or an affiliate of the issuer in a transaction or chain of transactions not involving any public offering. Control securities are any securities held by an affiliate of the issuer, regardless of how the affiliate acquired them. For example, securities acquired by an affiliate in a public offering are control securities.

As a result of the rule revisions, the application of the Rule 144 safe harbor depends on:

- Whether the issuer of the securities is a reporting issuer or a non-reporting issuer (as defined below);
- Whether the security holder is an affiliate or a non-affiliate of the issuer of the securities; and
- Whether the securities are equity securities or debt securities.

For simplicity, Sections B, C and D below describe the Rule 144 changes applicable to equity securities. Additional Rule 144 changes for debt securities are discussed separately in Section E below.

B. Holding Period Changes

1. Shortened Initial Holding Period for Restricted Securities of Reporting Issuers

The SEC amended Rule 144(d) by adopting a six-month, instead of one-year, initial holding period for restricted securities of reporting issuers. An issuer is a “reporting issuer” if it is and has been subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, (the “Exchange Act”), for at least 90 days immediately prior to the sale and has filed all required reports during the 12 months (or for such shorter period that the issuer was required to file such reports) preceding the sale. Voluntary filers are not reporting issuers. The six-month holding period applies to restricted securities of reporting issuers held by both affiliates and non-affiliates. No sales may occur in reliance on Rule 144 during this six-month period.

2. Initial Holding Period Unchanged for Non-Reporting Issuers

The SEC did not shorten the one-year holding period for restricted securities of non-reporting issuers, whether owned by affiliates or non-affiliates. No sales may occur in reliance on Rule 144 during this one-year period.

3. Hedging Activities Do Not Toll the Holding Period

The SEC proposed but did not adopt a provision that would have extended the holding period, in certain cases involving reporting issuers, up to an additional six months for any time during which the current or a former security holder had engaged in hedging transactions. The SEC stated that while hedging raises reasonable concerns about abuse of the reduced holding period, it decided not to adopt such a provision.

---

5 We define “non-affiliate” for the purposes of this publication as any person who is not an “affiliate” at the time of sale and has not been an affiliate during the prior three months. Rule 144(a)(1) defines an affiliate of an issuer as a person who directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the issuer.

4 Equity securities are those securities identified in Rule 405, including common stock, other equity interests and rights, options and warrants and securities convertible into or exercisable for equity securities.

5 Rule 144 defines “debt securities” to include (i) any security other than equity securities as defined under Rule 405, (ii) non-participatory preferred stock, which is defined as non-convertible capital stock, the holders of which are entitled to a preference in payment of dividends and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in residual earnings or assets of the issuer, and (ii) asset-backed securities as defined in Regulation AB.

6 The rule continues to provide that the holding period will not start running until the full purchase price or other consideration has been paid by the investor acquiring the restricted securities from the issuer or from an affiliate of the issuer.
C. Sales After the Initial Holding Period

1. Unlimited Sales Allowed for Non-Affiliates

As a result of the rule revisions, the dribble-out limitations (which include volume limitations on sales of securities) are no longer applicable to non-affiliates. Sales by non-affiliates of restricted securities after the applicable holding period are also no longer subject to the manner of sale and Form 144 notice requirements discussed below.

Non-affiliates may now sell an unlimited amount of restricted securities of a reporting issuer after the initial six-month holding period if the reporting issuer is in compliance with the current public information requirement. After a one-year holding period, non-affiliates may sell an unlimited amount of restricted securities of both reporting and non-reporting issuers, even if current public information is not available.

The current public information requirement of 144(c) is satisfied by reporting issuers who are current in their Exchange Act reporting requirements (other than Form 8-K reports) and by non-reporting issuers who have complied with paragraphs (a)(5)(i) to (xiv), inclusive, and paragraph (a)(5)(xvi) of Rule 15c2-11 under the Exchange Act (insurance companies have alternate obligations).

While paragraph (k) of Rule 144 has been eliminated, its substance has been incorporated into Rule 144(b) with the reduced holding period discussed above.

2. Dribble-Out Allowed for Affiliates

Affiliates may begin to dribble out restricted securities of (i) reporting issuers after a holding period of six months and (ii) non-reporting issuers after a holding period of one year. Affiliates may also dribble out control securities that are not restricted securities at any time because only restricted securities are subject to holding periods.

D. Changes to the Dribble-Out Limitations Applicable to Sales by Affiliates

Several modifications have been made to the dribble-out limitations applicable to affiliates.

1. Revisions to the Manner of Sale Requirement

The manner of sale requirement now explicitly permits the sale of securities through riskless principal transactions subject to certain considerations. The SEC has also revised the definition of “brokers’ transactions” to permit posting of bid and ask quotations in alternative trading systems.

2. Revisions to the Form 144 Notice Requirement

Previously, affiliates selling securities, and non-affiliates selling restricted securities prior to the end of a two-year holding period, were required to file a notice on Form 144. No Form 144 was required unless the security holder, within any three-month period, either (i) sold more than 500 shares or (ii) received proceeds of US$10,000 or more.

Under the revised Rule 144, the threshold for filing Form 144 has been raised to apply only to transactions within a three-month period where an affiliate either (i) sold more than 5,000 shares or (ii) received proceeds of US$50,000 or more.

---

7 Under the volume limitations of Rule 144(e), a security holder can not sell in any three-month period more than the greater of: (1) one percent of the shares or other units of the class outstanding as shown by the most recent report or statement published by the issuer, or (2) the average weekly volume of trading in such securities during the four calendar weeks preceding the filing of a Form 144, the receipt of the sale order by a broker or the date of sale to a market maker.

8 A “riskless principal transaction” is defined as a principal transaction where, after having received from a customer an order to buy, a broker or dealer purchases the security as principal in the market to satisfy the order to buy or, after having received from a customer an order to sell, sells the security as principal to the market to satisfy the order to sell.

The manner of sale requirement is satisfied by a riskless principal transaction in which (i) trades are executed at the same price (exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee), (ii) the rules of a self-regulatory organization permit the transaction to be reported as riskless and (iii) the transaction meets all the requirements of “brokers’ transactions” as defined in Rule 144(g).
The SEC considered but did not combine the Form 4 and Form 144 filing requirements. Form 4 is used to report changes in beneficial ownership under Section 16 of the Exchange Act.

E. Modification of the Dribble-Out Limitations for Debt Securities

The SEC adopted several further modifications of the dribble-out limitations specifically for sales of debt securities.

1. No Manner of Sale Requirement

The manner of sale requirement has been eliminated for sales of debt securities.

2. Revised Volume Limitations

The SEC has raised the volume limitations for debt securities. Subject to the applicable holding period for restricted securities, affiliates may sell debt securities in amounts that in the aggregate do not exceed 10 percent of a tranche (or class when the securities are non-participatory preferred stock), within a three-month period. As previously noted, sales by non-affiliates are no longer subject to volume limitations.

F. Shell Companies Under Rule 144

Rule 144 now includes specific provisions relating to shell companies. The changes prohibit reliance on Rule 144 by holders of securities initially issued by “reporting or non-reporting shell companies” (other than business combination related shell companies). These issuers have (i) no or nominal operations and (ii) either (a) no or nominal assets, (b) assets consisting solely of cash and cash equivalents, or (c) assets consisting of any amount of cash and cash equivalents and nominal assets.

Rule 144(i)(2) states that Rule 144 is only available for securities of such an issuer after:

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

“Form 10 information” means the information that an issuer would be required to file if it were registering a class of securities under the Exchange Act. Form 10 information is deemed to be filed on the date the information is initially provided to the SEC.

II. Codification of SEC Staff Positions

The SEC also codified seven interpretive positions of the staff of the Division of Corporation Finance, including the shell company position previously discussed. The remaining six are discussed below.

A. Sales of Securities Exempted Under Section 4(6)

The SEC codified the staff position that securities issued pursuant to an exemption from registration (for offerings up to $5 million) under Section 4(6) of the Securities Act of 1933, as amended, (the “Securities Act”), are restricted securities for purposes of Rule 144.

---

9 A “business combination related shell company” is defined in Rule 405 as a shell company that is (1) formed by an entity that is not a shell company solely for the purpose of changing the corporate domicile of that entity solely within the United States or (2) formed by an entity that is not a shell company solely for the purpose of completing a business combination transaction among one or more entities other than the shell company, none of which is a shell company.
B. Tacking of Holding Periods When Reorganizing Into a Holding Company Structure

The SEC codified the staff position allowing tacking of the holding period of securities surrendered in connection with a transaction made solely for the purpose of forming a holding company to the holding period of the newly acquired securities.

The new provision clarifies that tacking is permitted when:

- The newly formed holding company’s securities were issued solely in exchange for the securities of the predecessor company as part of a reorganization of the predecessor company into a holding company structure;
- Security holders received securities of the same class evidencing the same proportional interest in the holding company as they held in the predecessor company, and the rights and interests of the holders of such securities are substantially the same as those they possessed as holders of the predecessor company’s securities; and
- Immediately following the transaction, the holding company has no significant assets other than securities of the predecessor and its existing subsidiaries and has substantially the same assets and liabilities on a consolidated basis as the predecessor had before the transaction.

Historically, the staff has narrowly construed its interpretive position—for example, concluding that reorganizations involving contemporaneous IPOs may not meet the requirements to allow tacking.

C. Tacking of Holding Periods for Conversions and Exchanges

The SEC codified the staff position allowing tacking of the holding period of securities surrendered for cashless conversion or exchange to the holding period of the newly acquired securities, even if the surrendered securities were not convertible or exchangeable by their terms.

However, if:

- The original securities do not permit cashless conversion or exchange by their terms; and
- The security holder provides any consideration, other than securities of the issuer, to amend the original securities to allow for cashless conversion or exchange; then

the holding period for the newly acquired securities is permitted to tack only to the date that the original securities were so amended.

D. Tacking Upon Cashless Exercise of Options and Warrants

The SEC codified the staff position allowing tacking of the holding periods of options or warrants to the holding periods of the underlying securities upon the cashless exercise of the options or warrants, even if the options or warrants did not originally provide for cashless exercise by their terms. However, if:

- The original options or warrants do not permit cashless exercise by their terms; and
- The holder provides any consideration, other than securities of the issuer, to amend the options or warrants to allow for cashless exercise; then

the holding period for the underlying securities is permitted to tack only to the date that the original securities were so amended. This treatment is analogous to the treatment of conversions and exchanges.

The SEC also codified the staff position that does not allow tacking of the holding period of certain options or warrants that are not purchased for cash or property, such as those granted under an employee benefit plan. The staff takes the position that tacking is not justified if the options or warrants were not purchased, because the security holder has not assumed investment risk.
E. No Aggregation of Pledged Securities

The SEC has codified the staff position that allows a recipient of pledged securities upon foreclosure to sell those securities without aggregating its sales under the volume limitations with sales by other pledgees of the same pledgor.

F. Modification of Form 144 Representation to Accommodate Rule 10b5-1

The SEC codified the staff position that allows a selling security holder to modify the standard Form 144 representation that it had no material adverse information about the issuer on the date the form was signed to accommodate Rule 10b5-1 sales plans. Form 144 was amended to allow a representation that the security holder had no knowledge of material adverse information about the issuer as of (i) the date of the sales instructions or (ii) the date of the adoption of a written trading plan.

III. Rule 145

Rule 145(a) defines the exchange of securities in connection with a reclassification, merger, consolidation or transfer of assets that is subject to shareholder approval as a “sale” that requires registration under the Securities Act or an exemption. Rule 145(c) contains a provision, known as the presumptive underwriter provision, which states that persons, other than the issuer, who were affiliates of the target to such a transaction, are deemed to be “underwriters” of the securities they receive in the transaction.

In the rule changes, the SEC has eliminated the presumptive underwriter provision except when the Rule 145(a) transaction involves a shell company (other than a business combination related shell company). Security holders who continue to be subject to the presumptive underwriter provision may still sell in reliance on Rule 145 if the issuer has met the requirements of Rule 144(i)(2), as discussed in Section I.(F) above, except for the requirement that one year has elapsed since the time the issuer filed current Form 10 information.

IV. Regulation S Distribution Compliance Period for Category 3 Reporting Issuers Reduced

The SEC reduced the Regulation S distribution compliance period for Category 3 issuers that are U.S. reporting issuers. Previously, the securities of Category 3 U.S. reporting issuers were subject to a one-year distribution compliance period under Rule 903(b)(3)(iii). This period has now been reduced to a six-month distribution compliance period to conform to the changes in the Rule 144 holding period. No change has been made for non-reporting Category 3 issuers.

V. Asset-Backed Securities Transactions

The SEC did not extend the Rule 144 changes to Rule 190, which relates to resecuritization transactions. Instead, the SEC amended Rule 190 to preserve the same access to Rule 144 for asset-backed securities transactions that existed previously by reference to Rule 144(k). Rule 190, as amended, requires that two years elapse between the date when the securities were acquired from the issuer or an affiliate of the issuer and when the securities may be resecuritized under Rule 190.
VI. Practical Changes—Registration Rights

These rule changes will need to be reflected in registration rights agreements. For example, in Rule 144A offerings, we expect that investors will still be entitled to registration rights and penalty interest or liquidated damages in certain circumstances. However, issuers may be able to avoid filing a registration rights shelf or Exxon-Capital registration statement if the securities become freely transferable under Rule 144 and any legends are removed before the contractual deadline for registration.

VII. Conclusion

The changes in Rule 144 and the other rules largely preserve the existing requirements for affiliates contemplating sales of equity securities. Most public companies will not experience significant change as a result of these revisions in their on-going Rule 144 compliance for directors and executive officers. However, the revisions represent a substantial reduction in the requirements applicable to non-affiliate holders of reporting companies and to debt securities. These changes should be reflected in planning and preparing future transactions and may influence the strategies used to bring offerings to market. This publication does not provide a detailed description or analysis of all the issues raised by these rule changes.