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Financial Services Practice

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SEC Adopts Significant Changes to Rules 144 and 145

The Securities and Exchange Commission (the “SEC”) has adopted significant amendments to Rules 144 and 145 under the Securities Act of 1933, as amended (the “Securities Act”), which become effective on February 15, 2008.¹ In a nutshell, these amendments (the “Amendments”) reduce to six months the minimum holding period for resales of “restricted securities” of “reporting companies”² (non-reporting companies will continue to be subject to a one-year minimum holding period) and, after the applicable holding period, non-affiliates will be able to resell without concern for virtually any of the requirements currently imposed on sellers of restricted securities. Although contemplated when the Amendments were proposed,³ the SEC did not reintroduce “tolling” of the Rule 144 holding period for hedged positions.

The Amendments also make several other changes to Rule 144 and conforming changes to Rule 145 and certain other rules, and codify several staff interpretive positions relating to Rule 144. The Amendments will apply to securities acquired both before and after the effective date.

Attached to this client briefing is a chart summarizing the conditions that will be applicable to sales of restricted securities once the Amendments become effective.

I. Reduction of Holding Periods and Changes to Selling Restrictions

The most significant changes are the reduction of the Rule 144(d) holding periods for restricted securities and the elimination of virtually all resale restrictions for non-affiliates after the holding period has ended. While certain resale restrictions will continue to apply to affiliates,⁴ the Rule 144 “manner of sale” requirements were amended for equity securities and eliminated for debt securities.

A. Holding Periods. For an issuer that is and has been subject to Exchange Act reporting requirements for at least ninety days immediately prior to the sale, and has complied with those requirements in the twelve months prior to the sale (or any shorter time that the issuer has been a reporting company), the minimum holding period before restricted securities of reporting

1. Release No. 33-8869 (Dec. 6, 2007), 72 FR 71546 (Dec. 17, 2007) (the “Adopting Release”). <http://edocket.access.gpo.gov/2007/pdf/07-6013.pdf>

2. “Restricted securities” are defined generally as 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. See Securities Act Rule 144(a)(3). “Reporting companies” are issuers subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).

3. Release No. 33-8813 (June 22, 2007), 72 FR 36822 (July 5, 2007) (the “Proposing Release”).

4. An affiliate is “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, [the] issuer.” Securities Act Rule 144(a)(1). Generally, officers, directors and holders of ten percent or more of a class of voting securities of the issuer are considered affiliates.

companies can be publicly resold has been reduced from one year to six months. With respect to non-reporting issuers, the holding period will continue to be one year.⁵

Tolling. Prior to 1990, Rule 144 required suspension or “tolling” of the counting of days remaining in the holding period if a holder of restricted securities hedged the economic risk of those securities. The SEC dropped tolling in 1990, but has long been concerned that transferring the economic risk of restricted securities calls into question the investment intent of the holder.⁶ These concerns were heightened by the proposal to reduce the holding period, and the SEC thus proposed reinstating tolling for up to six additional months in cases where a restricted securities position was hedged. A number of commenters objected to this proposal, citing, among other things, concerns that tolling would unduly complicate the rule and lead issuers to incur significant costs to monitor hedging. The SEC decided not to reinstate tolling, but cautioned that it will revisit the issue if it observes abuses.⁷

B. Non-Affiliates – Fewer Selling Restrictions. Perhaps more significant than shortening of the holding period to six months is that, upon the expiration of that holding period, a non-affiliate of a reporting company will be permitted to resell restricted securities without regard to the volume restrictions, manner of sale, and Form 144 filing requirements. Only the current information requirement in Rule 144(c) will apply to sales by non-affiliates, and after one year, that requirement will cease to apply as well.

C. Affiliates. While virtually all selling restrictions have been eliminated for non-affiliates that have satisfied the holding period for restricted securities, sales by affiliates will

remain subject to certain restrictions.⁸ However, the SEC has streamlined those restrictions in several ways.

Equity Securities – Changes to the Manner of Sale Requirement. The SEC adopted two changes to the Rule 144(f) manner of sale requirements for resales of equity securities. First, the old rule required a “brokers’ transaction” (an unsolicited agency trade) or a transaction directly with a market maker. The Amendments will permit the use of a “riskless principal” transaction⁹ as well, provided that such transaction is unsolicited. The SEC also will consider posting of bid and ask quotations in alternative trading systems not to constitute “solicitation.” Thus, brokers will be permitted to enter bid and ask quotations for a restricted security in an alternative trading system provided the broker has published bona fide bid and ask quotations for the security in the system on each of the twelve business days before the posted bid and ask to resell.¹⁰

Debt Securities

Elimination of the Manner of Sale Requirement. While retaining the manner of sale requirements for sales of equity securities by affiliates, the Amendments eliminate them for sales of debt securities. According to the Adopting Release, the fixed income markets do not raise the same level of concern as the equity markets with regard to Rule 144 compliance, and the manner of sale requirements could “place an unnecessary burden on the resale of fixed income securities.”¹¹

5. 72 FR at 71549-71550. According to the SEC, “a six-month holding period for securities of reporting issuers provides a reasonable indication that an investor has assumed the economic risk of investment in the securities to be resold under Rule 144.” *Id.* at 71549. However, because the SEC is concerned about insufficient public information regarding non-reporting companies, it is maintaining a one-year holding period for such issuers. *Id.* at 71550.

6. *See, e.g.*, Release No. 33-7391 (Feb. 20, 1997), 62 FR 9246, 9251-9253 (Feb. 28, 1997).

7. Adopting Release, 72 FR at 71552.

8. Securities of an issuer held by an affiliate, *even if not restricted* (*e.g.*, because they were purchased in an ordinary secondary market transaction on a national securities exchange), generally must be sold pursuant to Rule 144. *See* Rule 144(b) (“any person who sells restricted or any other securities for the account of an affiliate of the issuer of such securities, shall be deemed not to be engaged in a distribution . . . and therefore not to be an underwriter . . . if all of the conditions of this rule are met) (emphasis added).

9. The Note to Rule 144(f)(1) defines a riskless principal transaction 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.” *See also* Rule 144(f)(1)(iii).

10. Rule 144(g)(3)(iv).

11. 72 FR at 71553-71554. The SEC also expanded the definition of debt securities to include non-participatory preferred stock and asset-backed securities. *Id.* at 71554.

Volume Limitations. Following the holding period, affiliates will continue to be subject to volume limitations. Generally, the amount of securities sold in any three-month period may not exceed the greater of one percent of the class outstanding or the average weekly trading volume of the security for the four calendar weeks prior to the sale. However, affiliates now will be able to resell debt securities in an amount that does not exceed the greater of ten percent of a tranche (or class in the case of non-participatory preferred stock) when aggregated with all sales of the same tranche sold for the account of the selling security holder within a three-month period.

Form 144 Filing Thresholds. Under the Amendments, only affiliates will be required to file reports on Form 144. The Amendments increase the volume thresholds that trigger Form 144 reporting requirements. Affiliates now will be required to file Form 144 only if intended sales exceed 5,000 shares or \$50,000 within any three-month period.¹²

II. Codification of Division of Corporation Finance Staff Positions

In addition to revising Rule 144, the SEC codified several interpretive positions that have been issued over the years by the staff of the Division of Corporation Finance in order to “make these interpretations more transparent and readily available to the public.”¹³

A. Securities Acquired Under Section 4(6). The SEC codified its position that securities acquired from the issuer pursuant to the exemption in Securities Act Section 4(6) are restricted securities. Under Section 4(6), an offering is exempt from registration if it does not exceed \$5 million, is made only to accredited investors, does not involve advertising or public solicitation, and is accompanied by the filing of a Form D. The SEC believes that securities acquired in Section 4(6) transactions should be treated the same as securities acquired in other non-public offerings covered by the definition of restricted securities.

B. Tacking of Holding Periods Upon Reorganization into a Holding Company. The SEC also codified its position that holders of restricted securities may include in their holding periods the time that their securities were held before a transaction by the issuer to form a holding company, provided that: (i) the newly formed company’s securities are issued solely in exchange for securities of the predecessor as part of a reorganization into a holding company; (ii) holders receive securities of the same class and proportional interest in the holding company as they held in the predecessor company, with substantially the same rights and interests; and (iii) immediately following the transaction, the holding company does not have any significant assets other than securities of the predecessor and its existing subsidiaries, and has substantially the same assets and liabilities on a consolidated basis. The SEC believes that this change is appropriate because in such reorganizations there is no significant change in the economic risk of the investment.

C. Tacking of Holding Periods for Conversions and Exchanges of Securities. Rule 144 does not explicitly state whether securities surrendered in exchange for securities of the same issuer must be convertible by their terms in order to permit a seller to tack the period that the securities were held before conversion to satisfy the holding period. The SEC has codified its position that, if the securities were acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities are deemed to have been acquired when the original securities were acquired, even if the original securities were not convertible or exchangeable by their terms. If the original terms do not permit cashless conversion or exchange and the parties amend them with the security holder providing consideration other than or in addition to securities of the issuer, then the exchanged or converted securities will be deemed to have been acquired on the date of the amendment.¹⁴

D. Tacking of Holding Periods for Cashless Exercises of Options and Warrants. The SEC also codified a staff position that, upon a cashless exercise of options or warrants, the newly acquired underlying securities are deemed to have been acquired when the options or warrants were acquired, even if the options or warrants originally did not provide for cashless exercise. If the options or warrants did not provide

12. The SEC solicited comments on coordinating filing deadlines for Form 144 and Form 4 under Exchange Act Section 16, and giving affiliates subject to the Section 16 reporting requirements the option of satisfying the Form 144 requirement by timely filing a Form 4. Proposing Release, 72 FR at 36830. The SEC did not adopt these changes, but noted that action is likely and will be addressed in a future release. Adopting Release, 72 FR at 71555.

13. *Id.*

14. *Id.* at 71556. Codification of this position was first proposed in 1997. See Release No. 33-7391, *supra* n.6, 62 FR at 9249.

for cashless exercise and the holder provides consideration other than or in addition to the issuer's securities in order to amend the options or warrants to permit cashless exercise, then the options or warrants will be considered to have been acquired on the date that the options or warrants were amended. However, because the SEC believes that options and warrants that are not purchased for cash or property (for example, employee stock options) do not create economic risk for the holder, the holder would not be allowed to tack the holding period of the option or warrant, and the securities would be considered to have been acquired on the date of exercise.¹⁵

E. Aggregations of Pledged Securities. The SEC added a note to Rule 144(e)(2)(ii), codifying its position that, so long as pledgees are not the same "person" under Rule 144(a)(2), each pledgee may sell pledged securities without aggregating the sale with sales by other pledgees of the same securities from the same pledgor, provided there is no concerted action by the pledgees. Each pledgee still must aggregate sales with the pledgor.

F. Securities Issued by Reporting and Non-Reporting Shell Companies. The SEC codified its position that Rule 144 is not available for resales of securities issued by companies that are or were reporting or non-reporting shell companies. As codified, this restriction applies to a broader universe of entities than those covered by the Rule 405 definition of shell company, in that it refers to any "issuer" meeting the standard, rather than only to "registrants." The restriction applies to all companies, other than asset-backed issuers, that meet the definition of "shell company" (other than business combination related shell companies), including blank-check companies. However, because the SEC does not believe that the same abuses are likely once a reporting company ceases to be a shell company and there is adequate disclosure in the market, the SEC will permit Rule 144 resales where: (i) the issuer has ceased to be a shell company; (ii) the issuer is subject to Exchange Act Section 13 or 15(d) reporting requirements; (iii) the issuer has filed all required Exchange Act reports and material during the preceding twelve months (or shorter time if only required to file for a shorter time); and (iv) at least one year has elapsed from the time the issuer filed "Form 10 information" reflecting that it is not a shell company.¹⁶

G. Representations from Holders Relying on Exchange Act Rule 10b5-1(c). Exchange Act Rule 10b5-1 defines when trading is "on the basis of" material nonpublic

information. Form 144 requires a representation, as of the date that the form is signed, that the seller "does not know any material adverse information in regard to the current and prospective operations of the issuer of the securities to be sold which has not been publicly disclosed." Form 144 filers now will be able to make those representations as of the date that they adopted written trading plans or gave trading instructions that satisfy Rule 10b5-1(c).

III. Other Changes

A. Amendments to Rule 145. According to Securities Act Rule 145(a), exchanges of securities in connection with reclassifications, mergers, consolidations, or transfers of assets that are subject to shareholder vote constitute "sales" of those securities, requiring registration (or an applicable exemption) upon resale. Rule 145(d) provides resale exemptions for persons presumed under Rule 145(c) to be underwriters of securities received in a Rule 145 transaction, incorporating the resale provisions of Rule 144. The SEC has eliminated the "presumptive underwriter" provision of Rule 145(c), except when a party to a Rule 145(a) transaction is a shell company (other than a business combination related shell company) or an affiliate or promoter thereof. This harmonizes the resale requirements of Rule 145(d) with the changes to Rule 144.

B. Regulation S Distribution Compliance Period for "Category Three" Issuers. The "distribution compliance period" for U.S. "Category Three" issuers under Regulation S has been changed to six months to coincide with the change to the Rule 144 holding period.

C. Underlying Securities in Asset-Backed Securities Transactions. Securities Act Rule 190 specifies when registration is required for the sale of underlying securities in asset-backed securities transactions. Generally, if the assets being securitized are themselves securities, the offering of the underlying securities must itself be registered or exempt from registration. Rule 190 requires the depositor of the underlying securities to be free to publicly resell the securities without registration. Under old Rule 144, if the underlying securities were restricted securities, the depositor was required to satisfy Rule 144(k), which imposed a two-year holding period. Because, under the Amendments, the underlying securities may be free from restriction after six months, the SEC, rather than changing the terms of the registration exemption for asset-backed securities, revised Rule 190 to require that if the underlying securities are

15. 72 FR at 71556.

16. *Id.* The Form 10 information will be deemed to have been filed at the time the *initial* Form 10 was filed with the SEC. Rule 144(i)(3).

restricted securities, a minimum of two years must have elapsed since the later of the date the securities were acquired from the issuer or from an affiliate of the issuer. The underlying securities can be re-securitized if they do not meet this holding requirement, but such transaction would require registration.¹⁷

D. Securities Act Rule 701(g)(3). Securities Act Rule 701 permits issuers, as part of certain compensation agreements, to offer their securities to employees, directors, partners, trustees, officers, and certain consultants, without the need to register the securities under the Securities Act. Rule 701(g) sets forth resale restrictions for such securities that are based on Rule 144. The SEC amended the Rule 144 references in Rule 701(g) to conform to the Amendments.

IV. Significance of the Amendments

On the whole, the Amendments appear to be a positive step for all participants in the restricted securities markets, making investments in restricted securities more attractive to investors, providing issuers with more efficient means of raising capital, and easing some of the burdens on brokers that effect sales under Rule 144. As we discussed when the

Amendments were first proposed,¹⁸ the Amendments should reduce the risks, costs, and burdens for holders of restricted stock, making private offerings more attractive to issuers and investors. By allowing restricted stock to be sold more quickly and with fewer restrictions, the Amendments should increase issuers' access to efficient sources of capital, especially issuers for which the public markets may not be a viable option. The Amendments also should reduce the "illiquidity discount" typically demanded by private placement investors, as well as the cost of maintaining "shelf" registration statements, which previously were required to be maintained for two years under Rule 144(k). Indeed, in some cases, issuers may find it unnecessary to offer registration rights in connection with certain private placements of equity securities. They also may increase the frequency (by reducing the additional interest expense) of "private-for-life" offerings of debt securities, in which issuers pay higher interest rates in order to avoid ever having to register the securities and thus having to comply with a host of requirements applicable to public companies (notably Section 404 of the Sarbanes-Oxley Act of 2002). Moreover, the codification of interpretive positions should bring greater certainty to investors regarding the treatment of their restricted securities.

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(Continued on next page)

17. *Id.* at 71560.

18. SEC Proposes Significant Changes to Rule 144, Winston & Strawn Client Briefing (July 2007)
http://www.winston.com/siteFiles/publications/SECProposes_Changes_Reg144.pdf

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Summary of Revised Rule 144

Sale by	Affiliate		Non-affiliate (and has not been an affiliate during the prior three months)	
Security Type	Equity Securities	Debt Securities	Equity Securities	Debt Securities
Securities of Reporting Issuers	During 6-month holding period: No resales under Rule 144 permitted		During 6-month holding period: No resales under Rule 144 permitted	
	<p>After 6-month holding period:</p> <p>Resale permitted subject to Rule 144 restrictions:</p> <ul style="list-style-type: none"> • <u>Current public information</u> • <u>Volume limitations:</u> Greater of 1% of shares outstanding or average weekly trading volume in 4 prior calendar weeks • <u>Manner of sale:</u> Brokers' transaction, transaction directly with market maker or riskless principal transaction • <u>Form 144:</u> If intended sales exceed 5,000 shares or \$50,000 	<p>After 6-month holding period:</p> <p>Resale permitted subject to Rule 144 restrictions:</p> <ul style="list-style-type: none"> • <u>Current public information</u> • <u>Volume limitations:</u> Greatest of 1% of shares outstanding, average weekly trading volume in 4 prior calendar weeks, or 10% of tranche (or class of non-participatory preferred stock) • <u>Manner of sale:</u> None • <u>Form 144:</u> If intended sales exceed 5,000 shares or \$50,000 	<p>After initial 6-month holding period:</p> <p>Resale permitted subject to Rule 144 restriction:</p> <ul style="list-style-type: none"> • <u>Current public information</u> <hr/> <p>After 1-year holding period:</p> <p>No Rule 144 restrictions apply</p>	
Securities of Non-reporting Issuers	During 1-year holding period: No resales under Rule 144 permitted		During 1-year holding period: No resales under Rule 144 permitted	
	<p>After 1-year holding period:</p> <p>Resale permitted subject to Rule 144 restrictions:</p> <ul style="list-style-type: none"> • <u>Current public information</u> • <u>Volume limitation:</u> Greater of 1% of shares outstanding or average weekly trading volume in 4 prior calendar weeks • <u>Manner of sale:</u> Brokers' transaction, transaction directly with market maker or riskless principal transaction • <u>Form 144:</u> If intended sales exceed 5,000 shares or \$50,000 	<p>After 1-year holding period:</p> <p>Resale permitted subject to Rule 144 restrictions:</p> <ul style="list-style-type: none"> • <u>Current public information</u> • <u>Volume limitations:</u> Greatest of 1% of shares outstanding, average weekly trading volume in 4 prior calendar weeks, or 10% of tranche (or class of non-participatory preferred stock) • <u>Manner of Sale:</u> None • <u>Form 144:</u> If intended sales exceed 5,000 shares or \$50,000 	<p>After 1-year holding period:</p> <p>No Rule 144 restrictions apply</p>	