



Chicago

35 West Wacker Drive
Chicago, IL 60601-9703
(312) 558-5600
Fax: (312) 558-5700

Geneva

43, rue du Rhône
1204 Geneva, Switzerland
41 0(22) 317 7575
Fax: 41 0(22) 317 7500

London

99 Gresham Street
London EC2V 7NG
44 (0)20 7105 0000
Fax: 44 (0)20 7105 0100

Los Angeles

333 South Grand Avenue
Los Angeles, CA 90071-1543
(213) 615-1700
Fax: (213) 615-1750

Moscow

4 Stasovoy Ulitsa
119071 Moscow
Russian Federation
7495-975-0623
Fax: 7495-973-0624

New York

200 Park Avenue
New York, NY 10166-4193
(212) 294-6700
Fax: (212) 294-4700

Paris

25, avenue Marceau
75116 Paris, France
(33) (0)1 53 64 82 82
Fax: (33) (0)1 53 64 82 20

San Francisco

101 California Street
San Francisco, CA 94111-5802
(415) 591-1000
Fax: (415) 591-1400

Washington, D.C.

1700 K Street, N.W.
Washington, D.C. 20006-3817
(202) 282-5000
Fax: (202) 282-5100

Corporate and Financial Services Practices

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SEC Proposes Significant Changes to Rule 144

The Securities and Exchange Commission (“SEC”) is proposing major changes to Rule 144 under the Securities Act of 1933, as amended (the “Securities Act”).¹ Most significantly, the SEC proposes shortening from one year to six months the minimum holding period for resales of “restricted securities” of “reporting companies.”² Restricted securities of issuers that are not reporting companies would continue to be subject to the current one-year holding period. After one year, all resale restrictions would end for non-affiliates of both reporting and non-reporting companies. The SEC also proposes to:

- reintroduce limited tolling of the Rule 144 holding period for hedged positions;
- eliminate the Rule 144 “manner of sale” requirement for debt securities;
- codify several interpretive positions regarding Rule 144;
- amend portions of Securities Act Rules 145, 190 and 701 that relate to Rule 144;
- eliminate Form 144 filing requirements for non-affiliates and raise the Form 144 filing thresholds for affiliates; and
- coordinate the filing of Form 144 and Form 4 under Exchange Act Section 16(a).

The proposed changes to Rule 144 (collectively the “Proposals”) represent the first time in 10 years that the SEC has addressed head-on the issue of holding periods and the effect that hedging the risk of a restricted securities position has on the analysis of whether the securities were purchased for investment or distribution. They also represent a fresh look at a number of related issues that have remained unanswered since the last round of proposed changes in 1997, and some new ones that have arisen since then.³ The SEC is seeking comments on the Proposals and it will be interesting to see the views of various market participants in light of the substantial changes in the securities markets, including the proliferation of automated trading systems, growth in sophistication of hedging strategies, and development of risk management techniques, which have occurred in the past 10 years.

The Proposals promise to reduce the risks, costs, and burdens for non-affiliates holding restricted stock, making private offerings more attractive to issuers and investors alike. By allowing

1. Securities Act Release No. 8813 (June 22, 2007), 72 FR 36822 (<http://www.sec.gov/rules/proposed/2007/33-8813fr.pdf>) (July 5, 2007) (the “Proposing Release”).

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. *See* Securities Act Release No. 7391 (Feb. 20, 1997), 62 FR 9246 (Feb. 28, 1997) (the “1997 Proposing Release”); Securities Act Release No. 7390 (Feb. 20, 1997), 62 FR 9242 (Feb. 28, 1997).

restricted stock to be sold more quickly, and with fewer restrictions once the applicable holding period is satisfied, the Proposals should provide issuers with greater access to efficient sources of capital, especially issuers for which the public markets may not be a viable option. The Proposals should reduce the “illiquidity discount” typically demanded by private placement investors and the expense inherent in maintaining “shelf” registration requirements for the current two-year period of Rule 144(k). The new rules also may increase the frequency of “private for life” offerings of debt securities, in which issuers agree to pay higher interest rates in order to avoid the obligation of ever having to register the debt securities and thus having to comply with a host of securities law requirements applicable to public companies (notably Section 404 of the Sarbanes-Oxley Act of 2002). Furthermore, because the Proposals would resolve the long-standing debate over hedging restricted stock by providing that hedging activities will not extend the minimum holding period beyond one year, investors who may have hesitated participating in private offerings by issuers whose securities carry greater risk now may be encouraged to do so. Finally, by codifying a number of well-established interpretive positions, the Proposals should bring greater certainty to investors regarding the treatment of their restricted securities.

All of this would appear to make the Proposals a positive step for all participants in the restricted securities markets, including public and private companies, venture capitalists, market intermediaries, and investors.

I. Background

Section 5 of the Securities Act generally prohibits offers and sales of securities unless they are registered or an exemption from the registration requirement is available. Section 4(1) of the Securities Act exempts “transactions by any person other than an issuer, underwriter or dealer.” Although Securities Act Section 2(a)(11) defines an “underwriter” as “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, or participates or has a direct or indirect participation in any such undertaking,” there is no specific definition or description of when a person is deemed to purchase securities with a “view to distribution.” In 1972 the SEC adopted Rule 144, a non-exclusive safe-harbor setting forth conditions that, when met, conclusively establish that the seller of unregistered securities purchased them without a view to distribution and thus did not act as an underwriter, therefore permitting the securities to be resold pursuant to Section 4(1).

II. Restricted Securities — Holding Periods and Tolling

A. Holding Periods

The SEC proposes shortening from one year to six months the holding period for public resales of restricted securities of companies subject to Exchange Act reporting requirements, provided that the issuer has been subject to those requirements for at least 90 days immediately prior to the sale and the seller has not hedged its position. This would apply both to affiliates⁴ and non-affiliates. For the next six months, non-affiliates of reporting companies would be permitted to sell subject only to the current information requirement in Rule 144(c), and thereafter could sell the securities without any restriction. Affiliates would continue to be subject to other applicable Rule 144 requirements after the initial six-month period, including public information, volume limitation, manner of sale, and Form 144 filing requirements.⁵ For restricted securities of non-reporting companies, non-affiliates would continue to be subject to a one-year holding period, but thereafter would be permitted to sell free of restrictions.⁶ Affiliates of non-reporting companies would be subject to a one-year holding period after which they could resell in accordance with applicable Rule 144 requirements.

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 10 percent or more of a class of voting securities of the issuer are considered affiliates.

5. 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).

6. Proposing Release, 72 FR at 36825-36826. According to the SEC, a six-month holding period for reporting companies is long enough to demonstrate that the investor assumed the economic risk of investment and did not purchase for distribution. However, the SEC is concerned about insufficient public information regarding non-reporting companies and thus believes that a one-year holding period for these issuers is more appropriate. *Id.*

B. Tolling

Prior to 1990, Rule 144 required suspending or “tolling” the counting of days remaining in the holding period if a holder of restricted securities hedged (*i.e.*, reduced) the economic risk of those securities. The SEC dropped the tolling provision in 1990 but now believes that, in light of its proposal to shorten the holding period, it may be appropriate to reinstate some form of tolling. The SEC has long held the view that bearing economic risk is critical to showing investment intent, and that transferring risk through hedging calls this intent into question.⁷ The concern now is that reducing the holding period to six months will make it significantly easier and cheaper to hedge. Accordingly, the SEC proposes that if the holder of restricted securities hedges the risk of those securities, the six-month holding period would be tolled while the position is hedged. Hedges that would result in tolling would include short positions in the security itself, and any “put equivalent position” as defined in Exchange Act Rule 16a-1.⁸ Notwithstanding the foregoing concerns, the SEC does not believe that the revived tolling requirement should result in a longer holding period than the one that applies currently. Instead, the SEC believes that one year between acquisition and resale adequately protects against indirect distributions of securities by the issuer to the public and proposes limiting tolling so that even where there are hedging transactions, the holding period would not exceed one year.

C. Tolling and Tacking

According to Rule 144(d)(1), the holding period operates from “the later of the date of the acquisition of the securities from the issuer or from an affiliate of the issuer.” Thus, a non-affiliate that purchases restricted securities from another non-affiliate is permitted to rely on that previous non-affiliate’s period of ownership (and that of any other non-affiliate from which that person acquired the securities) in determining how long the securities have been held — a process generally referred to as “tacking.”⁹ In order to harmonize the proposed

tolling requirement with the tacking process, the proposal calls for any previous non-affiliate’s holding period (or part thereof), during which the restricted securities were hedged, to be excluded from the current owner’s calculation of its holding period. The SEC proposes to require that the current owner “reasonably believe” that the previous owner did not hold a hedged position, “because it may be difficult . . . to determine definitively whether a previous owner had engaged in hedging activities with respect to the securities.”¹⁰ Nevertheless, as stated above, in no circumstance would the holding period exceed one year from the date of acquisition from the issuer or an affiliate of the issuer.

III. Elimination of Manner of Sale Requirements for Debt Securities

The SEC is also proposing to eliminate the “manner of sale” requirements for resales of debt securities under Rule 144(f), based on the view that the fixed-income securities market does not raise the same level of concern as the equity markets with regard to Rule 144 compliance. According to the Proposing Release, the goal of these rules is to ensure that special selling efforts and compensation arrangements usually associated with a distribution are not present in a Rule 144 sale. Debt securities, however, “generally are traded in dealer transactions in which the dealer seeks buyers for securities to fill sell orders instead of through the means prescribed in Rule 144(f)” and eliminating the manner of sale restrictions would allow greater flexibility in the resale process, including the ability to privately negotiate resales.¹¹

IV. Form 144 Filing Thresholds

Rule 144 currently requires selling security holders to file Form 144 if the intended sale exceeds either 500 shares or \$10,000 within any three-month period. As stated above, the SEC proposes allowing non-affiliates to sell after the six-month holding period subject only to the current information requirement, and after one year subject to no restrictions at all. Therefore, under the Proposals, only affiliates would be

7. *See, e.g.*, 1997 Proposing Release, 62 FR at 9251-9253.

8. A “put equivalent position” is “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.” Exchange Act Rule 16a-1(h).

9. Proposing Release, 72 FR at 36826 n.68. If an affiliate appears in the chain of ownership, however, a new holding period begins when a non-affiliate purchases the shares from the affiliate.

10. *Id.* at 36826. However, the SEC is seeking comment regarding whether a “bona fide belief” or other standard would be more appropriate. *See id.* at 36829.

11. *Id.* at 36829. Non-participating preferred stock (which has debt-like characteristics), and asset-backed securities, where the predominant purchasers are institutional investors, would be included in this exemption. *Id.*

required to file Form 144. Moreover, the SEC proposes raising the filing threshold to more than 1,000 shares or other units, or an aggregate sale price in excess of \$50,000, within any three-month period. The SEC also solicits comment on coordinating filing deadlines for Form 144 and Form 4 under Exchange Act Section 16, and giving affiliates subject to Section 16 filing obligations the option of satisfying the Form 144 requirement by timely filing a report on Form 4.¹²

V. Codification of Staff Positions Issued by the Division of Corporation Finance

In addition to proposing changes to Rule 144, the SEC proposes codifying several interpretive positions issued by the staff of the SEC Division of Corporation Finance, in order to “simplify the rule by making these staff positions more transparent and readily available to the public.”¹³

A. Securities Acquired Under Section 4(6)

The SEC proposes codifying 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 a Form D is filed. 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 proposes codifying the position that restricted security holders 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 the securities of the predecessor as part of a reorganization of the predecessor into a holding company structure; (ii) holders receive securities of the same class and of the same 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 is appropriate because the securities exchanged are substantially equivalent and there is no significant change in economic risk of the investment.

C. Tacking of Holding Periods for Conversions and Exchanges of Securities

Rule 144 does not 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 proposes to codify the staff 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 acquired when the original securities were acquired, even if the original securities were not convertible or exchangeable by their terms. However, if the original terms do not permit cashless conversion or exchange, and the parties amend the terms to allow such conversion with the security holder providing consideration other than or in addition to securities of the issuer, then the exchanged or converted securities are deemed acquired on the date of the amendment.¹⁴

D. Tacking of Holding Periods for Cashless Exercises of Options and Warrants

The SEC also proposes codifying 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 they originally did not provide for cashless exercise. If the options or warrants did not provide for cashless exercise and the holder provides consideration other than or in addition to securities of the issuer in order to amend the options or warrants to permit cashless exercise, then the options or warrants would be considered acquired on the date that the original 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 such options or warrants and the securities would be deemed acquired on the date of exercise.¹⁵

12. *Id.* at 36830. See Section IX, below.

13. *Id.*

14. *Id.* at 36831. Codification of this position was first proposed in 1997. See 1997 Proposing Release, 62 FR at 9249.

15. Proposing Release, 72 FR at 36831.

E. Aggregations of Pledged Securities

The SEC proposes adding a note to Rule 144(e)(2)(ii) codifying an interpretive position that so long as pledgees are not the same “person” under Rule 144(a)(2), each one may sell pledged securities without aggregating its sale with sales by other pledgees (*e.g.*, another broker-dealer or bank) of the same securities from the same pledgor, provided there is no concerted action by the pledgees. Each pledgee will continue to be required to aggregate sales with those of the pledgor.¹⁶

F. Securities Issued by Reporting and Non-Reporting Shell Companies

The SEC proposes to codify its interpretive position that Rule 144 is not available for resales of companies that are or were blank-check companies. The SEC would modify the interpretation to address securities of all companies, other than asset-backed issuers, that meet the definition of “shell company,” including blank-check companies. However, the restriction would apply to a broader universe of entities than those covered by the Rule 405 definition of shell company. It would apply to any “issuer” meeting the standard, rather than solely to “registrants” (*i.e.*, “reporting *and* non-reporting shell companies”). The SEC believes that the provision as proposed will better describe the types of issuers that are subject to the abuse that the interpretation is designed to address. Persons wishing to sell securities issued by a company that is, or was, a reporting or non-reporting shell company (other than a business combination related shell company) would not be able to use Rule 144. However, because the SEC does not believe that the same abuses are present once a reporting company ceases to be a shell company and there is adequate disclosure in the market, the SEC would permit Rule 144 resales where: (i) the issuer is subject to Exchange Act Section 13 or 15(d) reporting requirements; (ii) the issuer has filed all required reports and material during the preceding 12 months (or shorter time if only required to file for a shorter time); and (iii) at least 90 days have elapsed from the time the issuer filed current “Form 10 information” reflecting that it is not a shell company. An affiliate selling control securities would have to wait at least 90 days before being permitted to resell, and a holder of restricted securities would have to wait until the end of the Rule 144 holding period.¹⁷

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 securities to be sold which has not been publicly disclosed.” Under the Proposals, Form 144 filers would 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).¹⁸

VI. Amendments to Rule 145

According to Securities Act Rule 145(a), exchanges of securities in connection with mergers, reclassifications, consolidations, or transfers of assets, which are subject to shareholder vote, constitute “sales” of those securities, thus requiring registration (or an applicable exemption) if the securities are to be resold. Securities Act 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 proposes to eliminate the “presumptive underwriter” provision of Rule 145(c), except as it applies to shell companies (other than business-related shell companies) and their affiliates and promoters, and to harmonize the resale requirements of Rule 145(d) with the proposed changes to Rule 144.¹⁹

VII. 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. Thus, if the underlying securities are restricted securities, the depositor must satisfy Rule 144(k), which presently imposes a two-year holding period before a non-affiliate may sell free of restrictions. However, under the

16. *Id.* at 36831-36832.

17. *Id.* at 36832.

18. *Id.* at 36833.

19. *Id.* at 36833-36834.

Proposals, this holding period would be reduced to as little as six months. Rather than change the terms of the registration exemption for asset-backed securities at this time, the SEC is proposing to revise Rule 190 to require that if the underlying securities are 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 could be re-securitized if they do not meet this requirement, but the sale would require registration.²⁰

VIII. Securities Act Rule 701(g)(3)

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

IX. Coordination of Form 144 and Form 4 Filing Requirements

Finally, the SEC proposes revisions to the filing requirements of Rule 144(h), under which a sale of securities in reliance on Rule 144 exceeding 500 shares or \$10,000 aggregate sale price requires the seller to transmit to the SEC a Form 144 concurrently with placing the order to sell or the execution with a market maker of such a sale. As stated above, the SEC suggests raising the filing thresholds to 1,000 shares and \$50,000.

As discussed above, the SEC proposes eliminating most restrictions on non-affiliates' sales, including the Form 144

requirement, while such restrictions would continue to apply to affiliates. However, Exchange Act Rule 16a-3 requires an issuer's insiders (*i.e.*, officers, directors, and holders of more than 10 percent of a class of equity securities) to report beneficial ownership changes, including sales, on SEC Form 4. Although much of what is reported on Form 4 duplicates Form 144 disclosure, Form 4 does not require all of the information currently required on Form 144, and the deadline for filing Form 4 is two business days *after* the transaction. The SEC seeks comment on how best to reduce filing requirements, specifically: (i) revising the Form 144 filing deadline to coincide with the Form 4 deadline; (ii) permitting affiliates who must file both forms to file only Form 4; and (iii) revising Item 701 of Regulations S-B and S-K to require additional disclosure about the resale status of securities issued in unregistered transactions at the time the company first issues the securities. Coordinating Forms 4 and 144 could require certain revisions to each and, because certain information in the Form 144 might no longer be provided, additional disclosure could be necessary in registration statements or issuers' periodic reports.²¹

X. Request for Comments

Throughout the Proposing Release there are specific, detailed questions regarding each particular proposal, for which the SEC requests comments. In addition, the SEC is requesting comments generally regarding matters such as the proposed changes set forth in the Proposing Release, additional or different changes that may be necessary or appropriate, and other matters that may have an effect on the Proposals. The SEC encourages comments from any interested person, including the views of issuers, investors and other users of information about resales of restricted and control securities. Comments should be submitted by September 4, 2007.

If you have any questions regarding the matters discussed in this Client Briefing, or if you would like assistance in preparing comments for the SEC setting forth your views regarding the Proposals, please get in touch with your usual Winston & Strawn contact or any of the Firm's attorneys listed on the following page:

20. *Id.* at 36835.

21. *Id.* at 36835-36836.

New York Office**(212) 294-6700**

Edward J. Johnsen

ejohnsen@winston.com

(212) 294-4741

Jeffrey H. Elkin

jelkin@winston.com

(212) 294-6711

Chicago**(312) 558-5600**

James J. Junewicz

jjunewicz@winston.com

(312) 558-5257

Wayne D. Boberg

wboberg@winston.com

(312) 558-5882

Terrence R. Brady

tbrady@winston.com

(312) 558-5626

Gregory J. Bynan

gbynan@winston.com

(312) 558-7342

Leland E. Hutchinson

lhutchinson@winston.com

(312) 558-7336

Los Angeles**(213) 615-1700**

G. Thomas Stromberg

tstromberg@winston.com

(213) 615-1822

Paris**(33) 1-53-64-82-82**

Robert Flanigan

rflanigan@winston.com

(33 1) 53 64 82 51

Washington, D.C.**(202) 282-5000**

Nicole M. Crum

ncrum@winston.com

(202) 282-5742