

# Funds and Partners Benefit from SEC Changes to Rule 144 Resale Restrictions ©

by Mitchell S. Ames\*

Private equity funds, venture capital funds, hedge funds and their partners will see increased liquidity for their investments from new amendments to Rules 144 and 145 under the Securities Act of 1933 (1933 Act). The changes became effective on February 15, 2008 and apply retroactively.

The final amendments were issued by the Securities and Exchange Commission (SEC) in December. Rule 144 is a safe harbor from registration for resales of securities purchased in private transactions and securities held by affiliates, however acquired. Rule 145 governs resales of securities by affiliates in business combination transactions.

A lists the essential elements of the rule changes. While useful, it is no substitute for speaking with counsel, as applying Rule 144 or Rule 145 often requires complex legal analysis.

The changes to Rule 144 include:

- shortening the minimum holding period for resales of restricted securities of reporting companies to six months (from one year) for both affiliates and non-affiliates; and
- easing compliance for non-affiliates by eliminating all restrictions, other than the current information requirement, for resales of restricted securities of reporting companies after six months, and eliminating the current information requirement after one year (all of these restrictions previously applied for two years).

Additional changes to Rule 144 include (1) amending the manner of sale requirements for equity securities, and eliminating them for debt securities, (2) amending the volume limitations for debt securities, (3) raising the thresholds that trigger a Form 144 filing and (4) codifying various SEC interpretive positions related to the Rule.

The most significant change to Rule 145 eliminates the presumptive underwriter provision in connection with business combination transactions, except for transactions involving "shell" companies.

## Q & A

The following Q&A addresses some of the more common questions that funds and their partners (both limited and general) raise in connection with the resale of securities without registration in reliance on

---

\* Mr. Ames is a partner in the New York City office of Pepper Hamilton LLP. Mr. Ames advises private equity and venture capital firms on investments, fund formation, fund-raising and compensation matters, particularly in the health care and media verticals. Mr. Ames was recognized by Chambers USA as a leading transactional attorney in media for the last four years. Mr. Ames may be reached at 212.808.2723 or .

exemptions from registration under Rule 144 and Rule 145. The answers reflect the increased liquidity that will result from the new rule changes.

***Q1.1 What types of securities held by funds or their partners can be sold under Rule 144?***

A1.1 In the case of funds or their partners that are non-affiliates of an issuer that have not been affiliates of the issuer for at least three months preceding a sale, Rule 144 applies to "restricted securities." Generally, restricted securities are securities acquired in a private placement without registration under the 1933 Act. In the case of funds or their partners that are affiliates of an issuer, Rule 144 applies to restricted securities and "control securities." Generally, control securities are securities held by affiliates, however acquired (including in open-market purchases). Control securities also can be restricted securities if acquired in a private placement without registration under the 1933 Act. Control securities that are not restricted securities are not subject to a holding period requirement under Rule 144 under the new amendments (or under the previous rule). If control securities also are restricted securities, however, the holding period requirement does apply.

***Q2.1: A fund purchases fully paid membership interests in a private LLC. The LLC later converts to a corporation and launches its IPO. The fund receives shares of common stock of the new corporation in a cashless conversion of its membership interests. Can the fund tack the holding period of the membership interests to the holding period of the common stock for purposes of Rule 144?***

A2.1: The new rule changes codify the previously held SEC staff position that securities received in a cashless conversion or exchange (the common stock referred to above) from the same issuer without payment of other consideration are deemed acquired (*i.e.*, the holding periods of both securities are tacked together) when the convertible securities (the membership interests referred to above) were acquired. If the holder provides other consideration to amend the converted securities to permit cashless conversion or exchange, then the newly acquired securities are deemed acquired at the time of amendment. It is worth emphasizing that the original terms of the membership interests (which should be set out in the LLC's operating agreement) must provide for their conversion or exchange into common stock in the event of an IPO without the consent of the LLC's members. Absent a conversion or exchange feature, a conversion or exchange event results in the issuance of a new security and tacking is not permitted. The practice of making conversion or exchange part of the original terms of membership interests is long-settled and is unchanged by the SEC's codification for tacking in cashless conversions and exchanges.

***Q2.2: In Q2.1, the IPO is completed six months after the fund purchases the membership interests. Can the fund sell the shares of common stock of the new public company received in the IPO without registration in reliance on Rule 144?***

A2.2: The answer depends on whether the holding period is between six months and one year, and whether the issuer is a reporting company. Because the tacked holding period of the common stock is at least six months, new Rule 144 will permit a sale exempt from registration if, commencing 90 days after the IPO, the issuer is a "reporting company." If the issuer is a non-reporting company, new Rule 144 requires the seller to hold the security for at least one year. Before the new amendments, the securities would have to be held for at least one year whether or not the issuer was a reporting company. Reporting companies are

issuers that (1) are registered under the Securities Exchange Act of 1934 (1934 Act) for at least 90 days *and* (2) have filed all required reports (other than 8-Ks) during the prior 12 months (or such shorter period of its 1934 Act registration).

***Q2.3: If the fund is not an “affiliate” of the issuer at the time of the sale, and was not an affiliate of the issuer for three months preceding the sale, what other requirements of Rule 144 would apply to the fund’s resale?***

A2.3: Only one other requirement of new Rule 144 applies: the “current information requirement.” This requirement applies only if the securities are held at least six months but less than one year. If the securities are held at least one year, the requirement no longer applies. These changes create significant liquidity for non-affiliates. First, under the old rule, non-affiliates could not sell unless the securities were held for at least one year. Second, any sale by non-affiliates under the old rule would have been subject to the four other requirements of the rule until the securities were held for at least two years: the current information requirement, the manner of sale requirement, the volume limits and the Form 144 filing requirement. As noted, none of these requirements apply after one year under the new rule.

***Q3.1: A fund receives warrants exercisable for common stock from a private corporation in a bridge financing. The corporation later launches its IPO. The fund receives shares of common stock of the public company upon a cashless exercise of the warrants. Can the fund tack the holding period of the warrants to the holding period of the common stock for purposes of Rule 144?***

A3.1: Similar to the codification for cashless conversions and exchanges, the new rule codifies the long-held SEC staff position that securities received upon a cashless exercise of warrants (the common stock referred to above) from the same issuer without other consideration are deemed acquired (*i.e.*, the holding periods of both securities are tacked together) when the convertible securities (the warrants referred to above) were acquired. If the holder provides other consideration to amend the warrants to permit cashless exercise, then the newly acquired securities are deemed acquired at the time of amendment.

***Q4.1: A managing director of the GP of a closely held fund sits on the board of directors of a fund portfolio company that is a reporting company. The fund holds 10 percent of the outstanding voting securities of the reporting company. The director is granted compensatory options by the portfolio company that are exercisable for shares of the company’s common stock. Upon exercise, the director distributes the shares of common stock to the fund without consideration. The fund later distributes the same shares pro rata to its partners (limited and general) without consideration in accordance with the distribution provisions of the fund’s governing documents. Can a partner tack its holding period of the stock with that of the fund? Can the fund or a partner tack its holding period of the stock with the director’s holding period of the options?***

A.4.1: A partner’s holding period of the stock can be tacked with the fund’s holding period. This is because the pro rata distribution is not a sale, so there is no investment decision or assumption of new risk to cause a new holding period to start. In contrast, tacking of the option and common stock holding periods is not permitted. This is because options granted

to directors or employees as compensation do not involve an investment decision or assumption of risk until exercised.

***Q4.2: In Q4.1, is the fund an affiliate of the issuer for Rule 144 purposes? Are the fund limited partners considered affiliates of the issuer for Rule 144 purposes?***

A4.2: Determining affiliate or non-affiliate status is a facts and circumstances test. There are two rules of thumb: (1) the SEC generally presumes affiliate status based on ownership of voting securities of at least 10 percent and (2) when an individual controls a fund (such as through the GP of the fund), and the individual also is a director of the issuer, the fund will be deemed to be an affiliate of the issuer. Based on the foregoing, the ownership by the fund of 10 percent of the voting securities in Q4.1 leads to the presumption that the fund is an affiliate of the issuer. In addition, the fund will be deemed to be an affiliate of the issuer if the managing director sitting on the portfolio company's board also controls the fund (through the GP). In contrast, the fund limited partners should not be deemed to be affiliates of the issuer for Rule 144 purposes (unless they are affiliates of the issuer due to some other relationship). If the limited partners are not affiliates, they may sell the shares of common stock received in the distribution so long as the tacked holding period referred to in A4.1 is at least six months. As noted in A2.2, if the holding period is between six months and one year, the limited partners may sell in reliance on Rule 144 only if the issuer is a reporting company (as in Q4.1), and subject to the current information requirement; if the holding period is at least one year, however, the current information requirement does not apply.

***Q4.3: In Q4.1, is the fund GP an affiliate of the issuer for Rule 144 purposes?***

A4.3: As noted, this determination is a facts and circumstances test. Absent other facts in these circumstances, the answer to Q4.3 is yes. This is because the fund GP typically has the power to control the management and affairs of the fund, and the fund, through its managing director sitting on the issuer's board of directors, may be deemed to be an affiliate of the issuer (providing the fund with indirect control of the issuer).

***Q4.4: If the fund or the fund GP wishes to sell the common stock referred to in Q4.1 in reliance on the exemptions in Rule 144, what holding period will apply under the new rule?***

A4.4: As with non-affiliates (see A2.3), the new amendments to Rule 144 create significant liquidity for affiliates. The new changes permit an affiliate to sell the common stock after six months, so long as the issuer is a reporting company (if the issuer is a non-reporting company, then the holding period must be at least one year). Under the old rule, affiliates could not sell until after one year.

***Q4.5: Aside from shortening the holding period for resale by the fund or the fund GP in Q4.3, are the other requirements of the rule changed by the new amendments?***

A4.5: The new amendments do not eliminate the four other requirements of the rule (see A2.3) for affiliate resales, but they do relax the manner of sale requirement and the Form 144 notice requirement. The scope of the manner of sale requirement for the resale of equity securities by affiliates is now expanded to better reflect current trading practices and venues. The manner of sale requirement previously required securities to be sold in either a "broker's

transaction” or a transaction directly with a market maker. With the new changes, securities may now be sold through a third method...a “riskless principal transaction” (generally, a transaction by a broker or dealer executed at the same price specified in a buy or sale order, exclusive of any explicitly disclosed fee, so long as they can be reported by the rules of the SRO (self-regulatory organization) as riskless). In addition, brokers now may insert bid and ask quotations in an electronic trading system if the broker has published these quotations for the last 12 business days. The Rule 144 filing requirement as it applies to affiliates now requires a Form 144 Notice to be filed with the SEC (and the principal exchange on which the securities are listed) only if the affiliate sells more than 5,000 shares, or if the aggregate sale prices exceed \$50,000, within any three-month period. The previous limits were significantly lower: 500 shares or an aggregate sales price of \$10,000. The substantive aspects of the current information requirement have not changed, and the substantive aspects of the volume limitation requirement for the sale of equity securities also have not changed for affiliate sales (although the volume limitation requirement has changed for the sale of debt securities – see A5.1).

***Q5.1: Are debt securities treated differently than equity securities?***

A5.1: Yes. The new amendments to Rule 144 create significant liquidity for funds and their partners that are affiliates of the issuer and that wish to sell restricted debt securities or control debt securities without registration in reliance on Rule 144. First and foremost, the manner of sale requirement of the rule no longer applies to any sale of restricted debt securities or control debt securities. Second, the volume limitations on the resale by affiliates of restricted debt securities and control debt securities are now increased to 10 percent (from 1 percent) of all sales of the same tranche within a three-month period.

***Q5.2: A fund (or its partners) holds non-participatory preferred stock of an issuer. Is this stock treated as an equity security or debt security for Rule 144 purposes?***

A5.2: The SEC classifies non-participatory preferred stock, as well as asset-backed securities, as debt securities for Rule 144 purposes. Therefore, the new changes to Rule 144 that eliminate application of the manner of sale requirement and significantly increase the volume limits as to restricted debt securities or control debt securities similarly apply to non-participatory preferred stock (see A5.1).

***Q6.1: A fund acquires common stock in a PIPE (private investment, public equity) transaction and holds it for six months. Can the stock be sold by the fund in reliance on Rule 144 and, if so, what requirements of the rule apply?***

A6.1: The fund can resell the PIPE stock if the issuer is a reporting company; the fund will need to hold the stock for an additional six months (*i.e.*, a total holding period of at least one year) if the issuer is a non-reporting company (see A2.2). The extent to which other requirements apply to the sale depends on whether the fund is an affiliate or non-affiliate of the issuer. If a non-affiliate, see A2.3; if an affiliate, see A4.5. The result is to significantly increase liquidity for PIPE investors. Buyout or LBO funds that invest in PIPE securities typically are affiliates of the issuer. This is because they often acquire at least 10 percent of the outstanding voting stock of their targets, or have a contractual right to a board seat that is filled by an individual that also “controls” the fund (see A4.2). Again, determining affiliate or non-affiliate status is a facts and circumstances test.

***Q7.1: Under the new amendments to Rule 145, do funds or their partners that are affiliates of a public issuer and that are exchanging their securities of the issuer in a business combination have to comply with the resale requirements of Rule 145 (which are similar to the requirements of Rule 144)?***

A7.1: No. The amendments to Rule 145 eliminated these requirements, except as to shell companies (other than a shell company formed for redomiciliation or acquisition purposes) and their affiliates and promoters. Rule 145(c) previously presumed that parties (other than the issuer) to an exchange of securities in a business combination subject to shareholder vote were, together with their affiliates, “underwriters” of the securities acquired in the transaction and had to comply with the restrictions on resales of those securities set forth in Rule 145. The SEC also has harmonized the resale requirements of Rule 145(d) with the changes to Rule 144.

**Other Conforming Amendments**

The SEC adopted conforming changes to the changes to Rule 144 and Rule 145 that may be of interest to funds and their partners relating to trading in the U.S. after an exempt Regulation S offering, the securitization of Rule 144 restricted securities that are asset-backed, and offers and sales pursuant to compensatory benefit plans of non-reporting companies.

**ENDNOTES**

1 Whenever this article refers to non-affiliates, it should be assumed that the non-affiliate is not an affiliate of the issuer at the time of any sale and was not an affiliate of the issuer for at least three months preceding the sale.

2 Whenever this article refers to a holding period that applies to affiliates, it should be assumed that the securities being discussed are restricted securities.

3 The concept of a cashless conversion or exchange, or a cashless exercise (see A3.1), refers to payment of the conversion, exchange or exercise price solely by delivery (or withholding) of securities of the issuer, typically shares of common stock that are issuable upon the conversion, exchange or exercise that have a market value at the time of delivery equal to that price.

4 It is typical for the underwriter of an IPO to require pre-existing shareholders to sign a lock-up agreement restricting the sale of their shares for 90-180 days after the IPO, regardless of the holding period of the securities.

5 The questions of whether there is an investment decision or assumption of new risk are typical when analyzing whether a holding period can be tacked.

6 As noted in A2.3, the Rule 144 manner of sale requirements no longer apply to sales by non-affiliates who hold their securities at least six months.

7 Also as noted in A2.3, the new changes no longer require non-affiliates to satisfy the Form 144 filing requirement.

8 Again as noted in A2.3, the new changes no longer require non-affiliates to satisfy the manner of sale requirement when selling in reliance on Rule 144.

9 References to debt securities mean non-convertible debt securities. Convertible debt securities are considered to be equity securities under Rule 144.

10 The increased liquidity of PIPE investments has attracted the interest of investors that previously avoided them and is likely to result in a decrease in the cost of capital to issuers.

---

### Summary of Rule 144 Changes

	New Rule 144	Old Rule 144
<b>Holding Period</b>	<p><b>Affiliates:</b></p> <p><u>After six months</u> – resales of restricted securities of reporting companies permitted, subject to:</p> <ul style="list-style-type: none"> <li>• Current public information</li> <li>• Volume limitations</li> <li>• Manner of sale for equity securities only</li> <li>• Filing Form 144</li> </ul> <p><u>After one year</u> – like the old Rule, resales of restricted securities of non-reporting companies permitted, subject to all of the above requirements.</p> <p><b>Non-affiliates: *</b></p> <p><u>After six months</u> – resales of restricted securities of reporting companies permitted in unlimited amounts, subject only to current public information requirement</p> <p><u>After one year</u> – resales of restricted securities permitted in unlimited amounts without any other requirements</p>	<p><b>Affiliates:</b></p> <p><u>After one year</u> – resales of restricted securities of reporting companies and non-reporting companies permitted, subject to:</p> <ul style="list-style-type: none"> <li>• Current public information</li> <li>• Volume limitations</li> <li>• Manner of sale for equity and debt securities</li> <li>• Filing Form 144</li> </ul> <p><b>Non-affiliates:</b></p> <p><u>After one year</u> – resales of restricted securities of reporting companies and non-reporting companies permitted, subject to:</p> <ul style="list-style-type: none"> <li>• Current public information</li> <li>• Volume limitations</li> <li>• Manner of sale for equity and debt securities</li> <li>• Filing Form 144</li> </ul>

		After <u>two years</u> – resales of restricted securities of reporting companies and non-reporting companies permitted in unlimited amounts without any other requirements
<b>Current Public Information</b>	<p><b>Affiliates:</b> No change</p> <p><b>Non-affiliates:</b> Current public information requirement no longer applies after one year</p>	<p><b>Affiliates in all cases/Non-affiliates for restricted securities held more than one but less than two years:</b> Reporting companies must (1) be registered under the Exchange Act for at least 90 days <i>and</i> (2) have filed all required reports (other than 8-Ks) during prior 12 months (or such shorter period of its Exchange Act registration)</p> <p>For non-reporting companies, requirement met by making certain information publicly available, including three years' financial statements</p>
<b>Manner of Sale</b>	<p><b>Affiliates:</b> Applies only to equity securities, not debt securities; expanded to permit sales of equity securities in "riskless principal transactions," and to permit brokers to insert bid and ask quotations in an electronic trading system</p> <p><b>Non-affiliates:</b> Manner of sale requirement no longer applies</p>	<p><b>Affiliates in all cases/Non-affiliates for restricted securities held more than one but less than two years:</b></p> <ul style="list-style-type: none"> <li>• Must be sold in broker's transactions or directly with "market maker"</li> <li>• Sellers may not solicit sales or make any payment other than to broker</li> <li>• Applies to equity and debt securities</li> </ul>
<b>Volume Limitations</b>	<p><b>Affiliates:</b> No change, except to raise the threshold for resales of restricted debt securities to 10 percent (from 1 percent)</p> <p><b>Non-affiliates:</b> Volume limitations no longer apply</p>	<p><b>Affiliates in all cases/Non-affiliates for restricted securities held more than one but less than two years:</b></p> <p>Amount sold, together with all sales of any restricted and other securities of the same class sold within the preceding three months, must not exceed the greater of:</p> <ul style="list-style-type: none"> <li>• 1 percent of the outstanding shares of that class; or</li> <li>• the average weekly reported trading volume during preceding four weeks</li> </ul>
<b>Form 144 Filing</b>	<p><b>Affiliates:</b> Filing required for sales in any three-month period over 5,000 shares or \$50,000</p> <p><b>Non-affiliates:</b> No longer applies</p>	<p><b>Affiliates in all cases/Non-affiliates for restricted securities held more than one but less than two years:</b></p> <p>Filing required for sales in any three-month period over 500 shares or \$10,000</p>
* In all cases, must not have been an affiliate of the issuer during the previous three months		