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### Practice Areas

Securities and Venture Capital

## Good Company

### Partial Relief for Private Investors: SEC Liberalizes Rules for Resales of Privately-Placed Securities

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The U.S. Securities and Exchange Commission (SEC) recently adopted amendments to its Rule 144 that liberalize the resale rules for privately-placed securities in several circumstances. The rules went into effect on Feb. 15, 2008 and promise to make it easier for investors in small, privately-held companies to dispose of their shares.

#### Regulatory Background

In general, the registration provisions of the federal Securities Act of 1933 (Securities Act), as well as state securities laws, require a person who seeks to sell securities (e.g. stocks, bonds, and other ownership interests in a company) to register the sale of those securities with the SEC and/or state securities regulators, unless the transaction qualifies for an exemption from registration. Given the large effort and expense involved in registering securities for sale, often the only practical way of selling securities is through an available exemption from the registration requirements. Many public companies when they are in a hurry, and almost all privately-held companies under any circumstances, will seek to take advantage of one of the exemptions from the registration requirements for privately-placed securities.

Under the popular exemption in SEC Rule 506, a public or privately-held company will sell securities under common private placement restrictions, i.e. without any general solicitation of investors, only to investors who have the sophistication and business experience to understand the merits and risks of owning the securities, and under various technical offering restrictions designed to make sure that the securities are bought and held by the private investors for a substantial period of time. Securities that are privately-placed in this manner become "restricted securities" under various provisions of the securities laws, to ensure that they are not quickly re-sold as part of a larger distribution of the securities, which is considered antithetical to the concept of a private placement.

The SEC promulgated Rule 144 as a safe harbor rule to allow the holders of restricted securities to publicly<sup>[1]</sup> re-sell their securities upon fulfilling several conditions. Under Rule 144 as it read previously, restricted securities were required to be held by the investor for a period of at least one year. Re-sales could occur between the first and second anniversaries of the investment but were required to be made under several substantial conditions: the issuer had to be a public company current in its reports made under the Securities Exchange Act (Exchange Act), e.g. Forms 10-K, 10-Q, 8-K; sales could not exceed certain volume limits; and the re-sale transactions could not involve any special selling efforts resembling underwriting arrangements. Typically, the re-selling

investors would be required to obtain legal advice and a legal opinion covering the transaction. Re-sales occurring after the second anniversary of the investment could be made freely, without compliance with these conditions.

Rule 144 differentiates between investors who are “affiliates” of the company issuing the securities, and those who are not. Briefly, an affiliate is a person or entity that exerts a controlling influence (or has the power to do so) over the company, either through a position as a director or executive officer of the company, or as a major (i.e. 5% or greater) shareholder in the company. Affiliates are generally treated more restrictively, due to their presumed ability to cause the company to register a re-sale of the company’s securities. Under Rule 144, affiliates are never entitled to re-sell their securities freely.

### **Impetus for the Changes**

Over the last several years, private placement activity by public companies has exploded in volume. Many large public companies, instead of seeking bank loans to finance short-term capital needs, have found a ready market on Wall Street for their securities on a private placement basis. With the shift in emphasis in the markets from individual retail investors toward large, professionally-run mutual funds and hedge funds, companies have had many opportunities to forego the cumbersome and time-consuming process of arranging an underwritten public offering of their securities in favor of private placements to these institutional investors.

One of the most important sets of regulatory initiatives by the SEC in recent years has been a long-term and comprehensive effort to foster and accommodate this rapidly-growing private placement market in public company securities. The SEC issued recent amendments to Rule 144 as part of this effort, to allow companies to issue their securities to institutional investors without having to register the re-sale of those securities on behalf of the investors. However, the benefit of the rule changes is not limited to large public companies. Investors in privately-held companies will also find that the obstacles to re-sale of privately-placed securities have been reduced.

### **Key Rule 144 Amendments**

Instead of requiring holding periods for non-affiliates of one year, with conditions, and two years, without conditions, the SEC shortened those holding periods. Under the new Rule 144, holders of restricted securities who are not affiliates of the issuer may now re-sell those securities after a six-month holding period, subject to certain conditions. Non-affiliate investors holding restricted securities for a one-year period are now entitled to re-sell those securities without any substantial conditions.

Specifically, if the investor is not an affiliate and the company is current in its Exchange Act reports, then the investor may re-sell restricted securities under Rule 144 after a six-month holding period without complying with the volume limit and manner of sale conditions. However, if the company is not a public company or is not current in its Exchange Act reports, then a non-affiliate investor may re-sell restricted securities after a one-year holding period, without complying with those conditions.

Investors who are affiliates of the issuer of the securities are subject to a shortened six-month holding period, after which they continue to be subject to most of the conditions provided in the old Rule. That is, the issuer must be current in its Exchange Act reports and the investor must observe the prescribed volume limits and the manner of sale conditions. Debt securities (bonds, debentures and notes) are subject to more liberal manner of sale and volume limit rules.

The upshot of the rule changes is that a typical passive (i.e. non-affiliated) investor in a private placement by a small, privately-held company need no longer hold the securities for a two-year period before freely re-selling them. Instead, such a person is only required to hold the privately-placed securities for a one-year period before freely re-selling them.

The new rules have broad effect going-forward. Investors holding securities that were privately-placed prior to the



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February 15, 2008 effective date of the new rules may use the new rules for their re-sales the same as investors who acquired their securities after February 15, 2008.

*The above discussion of Rule 144 represents a brief and simplified discussion of highly technical rules. A discussion of many of these technical rules lies beyond the scope of this article. Investors who are considering investing in privately-placed securities or who hold restricted securities and are considering disposing of them, should consult with qualified counsel who can advise them of the impact of these technical requirements on the investors' situation.*

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[1] Under the so-called Section 4(1 ½) exemption from the registration requirements, a holder of restricted securities is always free to re-sell the securities in another private placement transaction. Rule 144 addresses the public re-sale of restricted securities, i.e. re-sales that do not meet the private placement requirements.