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The SEC's December 2007 Rule Revisions: Updates to Standard Transaction Documentation for Financial Intermediaries

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As many of you are aware, the SEC passed a number of important rule revisions in December 2007, relating to:

- Rule 144;
- Form S-3/F-3 eligibility; and
- reporting requirements of "Smaller Reporting Companies."

We have summarized these revisions in our prior client alerts.[1] This alert is principally intended to remind our clients who act as financial intermediaries of the changes to their principal standard transaction documents and forms they might consider as a result of these amendments.

Summary of the Amendments

Rule 144. The amendments relax the restrictions of Rule 144 by:

- reducing the current minimum holding period for restricted securities issued by reporting companies from one year to six months;
- permitting persons who have been non-affiliates of the issuer for the past 90 days to sell unlimited amounts of restricted securities after a six-month holding period, as long as the issuer meets Rule 144's current public information requirement, and to sell restricted securities without any conditions after a one-year (as opposed to the prior two-year) holding period; and
- eliminating the Form 144 notice requirement for sales by non-affiliates and increasing the thresholds that trigger the Form 144 filing requirement for proposed sales by affiliates.

Short Form Registration. As to Form S-3 and Form F-3, the amendments will enable a company that has less than $75 million in public equity float to register its primary securities offerings on one of the forms if it:

- meets the other eligibility requirements of the relevant form;
- is not and has not been a shell company for at least 12 calendar months prior to the filing of the form;
- has a class of common equity securities listed on a national securities exchange; and
- does not sell in a 12-month period more than the equivalent of one-third of its public float.

Smaller Reporting Companies. Finally, the amendments relax certain SEC reporting requirements in registration statements and Exchange Act filings for companies with a public float of less than $75 million, creating a new category called "Smaller Reporting Companies."

Revisions to Underwriting Agreements, Placement Agency Agreements and Similar

Documents

Representations and Warranties. In the case of registration statements on Form S-3 or F-3, these sections of underwriting agreements, placement agency agreements and purchase agreements may be updated to more appropriately state the basis upon which the issuer qualifies to use the relevant form for registration, and that the relevant conditions set forth in the revised rules are satisfied. For example, these representations may include statements (a) that the relevant offering, combined with other short-form offerings registered under the new rules, do not exceed 1/3 of the issuer's public float, and (b) that the issuer has not been a "blank-check" company during the preceding year. In addition, where an issuer's disclosures are "scaled" in accordance with the new requirements for smaller reporting companies, the issuer should represent explicitly that it qualifies for the more lenient treatment.

Legal Opinions. In the case of registration statements on Form S-3 or F-3, the required legal opinions, including the so-called "compliance as to proper form" opinion, will need to be updated to more appropriately state the basis upon which the issuer qualifies to use the relevant form for registration, and that the relevant conditions set forth in the revised rules are satisfied.

Comfort Letters. Smaller Reporting Companies are no longer required to have financial statements that comply with all of the provisions of SEC Regulation S-X; instead, their financial statements will be principally regulated solely by GAAP. Accordingly, it may be appropriate to discuss with the applicable issuer's auditors at the outset of an offering to determine the basis on which the applicable financial statements have been prepared, and whether the proposed "form of" language of the comfort letter set forth in an underwriting agreement or similar document is consistent with that approach.

Lock-up Agreements. As a result of the amendments to Rule 144, after a six-month holding period, non-affiliates will have the ability to resell shares of the issuer, without regard to the Rule 144 volume limitations. Accordingly, underwriters may seek to consider whether it is appropriate for IPO and/or follow-on offerings to be followed by lock-up periods for some or all of the relevant securityholders that exceed the existing six-month/three-month standard periods. In addition, with respect to many IPOs, underwriters may be more inclined to ensure that *all* pre-IPO stockholders are subject to lock-up agreements, as opposed to only locking-up those stockholders who have holdings which exceed a certain percentage. Changes of this kind may help prevent substantial resales of the pre-IPO stock in the market after the IPO.

Revisions to Registration Rights Agreements and Other Documents in PIPEs and Other Private Placements

Effectiveness of Registration Statement. To date, a standard covenant for maintaining the effectiveness of a resale registration statement for restricted securities would have been to maintain the effectiveness of the registration statement until the later to occur of (a) two years or (b) the date that the selling securityholders could resell the securities without limitation under Rule 144. In light of the amendments to Rule 144, the former period may be reduced to one year.

Current Information Requirement. To date, a standard covenant for providing "current information" to enable non-affiliated selling securityholders to use Rule 144 would have been two years. In light of the amendments to Rule 144, this period may also be reduced to one year.

Liquidated Damages—Timing and Amounts. In connection with an offering, a placement agent should consider whether:

- the liquidated damages payable by an issuer for failure to cause a registration statement to be filed, to become effective or to remain effective should decrease, or even increase, as a result of the reduced holding periods applicable under amended Rule 144; and
- whether these damages should begin to apply on an earlier date. For example, should the issuer's "deadline" for filing and/or having the registration statement declared effective be accelerated to an earlier date than would have applied under the prior rules?

The factors in making these decisions will include, for example:

- whether any of the selling securityholders are affiliates of the issuer, such that the volume limitations of Rule 144 will continue to apply for a longer period of time; and

- whether the issuer has any known existing disincentive to diligently prepare and process the registration statement.

Piggy-Back Registration Rights. Some registration rights agreements used in private placement transactions enable the purchaser to participate as a seller in subsequent underwritten offerings by the issuer. To the extent that the Rule 144 amendments reduce a securityholder's holding periods and volume limitations, these provisions are likely to be less appropriate in many transactions. A non-affiliated selling stockholder is likely to be able to reduce or eliminate its position under amended Rule 144 without having to participate in an underwritten offering.

Provisions for Removing Restrictive Legends. To date, many registration rights agreements have not provided for the automatic removal of restrictive legends from the certificates representing the restricted securities. Instead, many agreements have provided for the removal of the restrictive legends only at the time of a proposed resale, (a) upon evidence that the relevant resale registration statement has been declared effective or (b) upon delivery of certifications and letters from counsel that the resale was made in accordance with Rule 144. We anticipate that as a result of the Rule 144 amendments, investors in private rounds will seek provisions that require the issuer to remove the restrictions from the relevant certificates on the six month anniversary of the closing date, except in the case of restricted securities held by affiliates of the issuer.

Brokers' Warrants. The Rule 144 amendments codify the SEC's existing staff interpretation that, in the case of warrants with a cashless exercise feature, the holding period of the warrants themselves will be tacked to the holding period of the underlying equity security. Accordingly, placement agents should review their forms to confirm that the brokers' warrants received as compensation in private capital-raising transactions include a cashless exercise provision.

Revisions to Registration Rights in Rule 144A Offerings of Debt Securities

Rule 144A offerings of debt securities issues by reporting companies often involve two types of registration rights in order to provide investors with liquidity:

- High-yield and similar offerings of non-convertible debt typically involve a so-called "Exxon Capital" exchange offer, in which the issuer agrees to issue a registered class of substantially identical debt in exchange for the Rule 144A debt.
- Convertible debt offerings under Rule 144A typically involve the issuer's agreement to file a resale registration statement, enabling the investors to resell the underlying shares of common stock.

Due to the amendments to Rule 144, in many instances, it will be less important, or unnecessary, for either of these types of registration rights to apply. This will particularly be the case where, as frequently occurs in a Rule 144A offering, no affiliate of the issuer is involved in the chain of ownership of the securities after the closing of the offering. Under these circumstances, the new six-month holding period under Rule 144 is likely to expire prior to, or around the same time as, the 180-day or 270-day "deadline" for registration statement that is typically set forth in the registration rights agreements for these offerings. In these cases, in lieu of agreeing to file a registration statement, an issuer may agree to remove the resale restriction on the relevant securities six months, or in some cases, one year, after the closing date.

In order for this approach to work, it will be important for the issuer and the placement agent or initial purchaser to ensure that affiliates of the issuer are not in the chain of ownership of these securities after the closing. If any affiliates do in fact become owners, these securities will need to be treated differently from the rest of the class, in order to ensure compliance with Rule 144. Accordingly, if this approach is followed, it may be appropriate:

- to add explicit warnings in the offering documents that the securities should not be purchased by affiliates of the issuer; and
- add documentation as a condition to the closing in which one or more affiliates of the issuer agree that they have no intention of purchasing, and will not purchase, the relevant securities in the offering, or in the after-market.

Delivery Mechanics

Several processes will need to be updated in the market to facilitate transfers of restricted securities

after the six-month holding period. In the case of equity securities, issuers and their counsel will need to coordinate with their transfer agents to ensure the timely removal of the relevant restrictive legends, and replacement of legended certificates with "clean certificates." In the case of Rule 144A transactions, arrangements will need to be made to remove the Rule 144A designation from the CUSIP number for the relevant securities. We anticipate that new covenants will be needed for the applicable transaction documents to put these mechanisms into place.

Revisions to Broker Representation Letters for Rule 144 Sales

In connection with Rule 144 sales, broker-dealers customarily furnish issuer's counsel and the relevant transfer agent with representation letters establishing that the sale was made in compliance with Rule 144. Often, brokers will have multiple forms of letters, for use in different circumstances, depending upon whether:

- the selling securityholder is or is not an affiliate of the issuer; and
- the selling securityholder has or has not held for a sufficient period of time so as not to be subject to Rule 144's volume limitations.

As a result of the Rule 144 amendments, each of these forms of letters is likely to require revision.

Revisions to Compliance Manuals Relating to Rule 144 Sales

The relevant provisions of each broker-dealer's compliance manuals should be updated to reflect the new provisions of Rule 144:

- the revised forms of representation letters described above, and when they are used; and
- the revised thresholds for determining when a Form 144 must be filed with the SEC in connection with a sale.

In addition, the amendments to Rule 144 codify a number of prior SEC staff interpretations relating to Rule 144, including:

- securityholders may tack the Rule 144 holding period in connection with transactions made solely to form a holding company;
- a pledgee of securities may sell pledged securities without having to aggregate the sale with sales by other pledgees of the same securities from the same pledgor as long as there is not concerted action by those pledgees;
- Rule 144 is not available for the resale of securities issued by companies that are, or previously were, blank check companies; and
- the form of certain representations that are required from security holders relying on Exchange Act Rule 10b5-1(c) in connection with a Rule 144 sale.

In light of the additional certainty provided by the SEC's codification of these positions, it would be worthwhile for institutions to verify that their compliance manuals in fact conform to these provisions.

Conclusion

We anticipate that a variety of market practices will evolve in transaction documentation after the effective date of the new rules to address the issues discussed in this Client Alert. We intend to continue to advise clients of the material trends that we see emerging in the market in response to these rule amendments, and where appropriate, to suggest new or additional changes to transaction and compliance documentation.

Footnotes:

[1] These summaries may be found at the following links:

- http://www.mofo.com/news/updates/files/13119.html

- http://www.mofo.com/news/updates/files/13257.html
- http://www.mofo.com/news/updates/files/13245.html