In December 2007, the SEC adopted several rule revisions, including shortening the Rule 144 holding period (among other changes to this rule), easing the eligibility requirements for use of short-form registration statements on Form S-3 and F-3 and relaxing the reporting requirements of a new class of issuers called ‘smaller reporting companies’. These amendments address recommendations made by the SEC Advisory Committee on Smaller Public Companies, which had issued a report proposing changes to the regulation of securities offerings, especially exempt offerings, as well as changes in corporate governance and compliance requirements applicable to smaller public companies. Although the amendments were intended principally to benefit, and indeed will benefit, smaller public companies, they will have more far-reaching effects on capital formation. The changes to Rule 144 and the eligibility requirements for use of Form S-3/F-3 will change the way in which issuers, both large and smaller companies, access the capital markets, as well as result in changes to certain financing methodologies.

Rule 144 permits the resale of restricted securities, subject to certain conditions, without registration under the 1933 Act and provides a non-exclusive safe harbour for security holders reselling restricted securities, so that selling security holders that comply with the rule requirements have the certainty of not being deemed to be ‘underwriters’. Restricted securities include securities of pre-IPO companies, securities issued by public companies pursuant to an exemption or exclusion from registration, such as in a private placement, a PIPE or a 144A offering, and affiliate or ‘control’ securities. In brief, the amendments to Rule 144 reduce the current minimum holding period for restricted securities issued by reporting companies from one year to six months; permit persons who have been non-affiliates of the issuer for the prior 90-day period 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 (in contrast to the previous two-year) holding period requirement; and eliminate the Form 144 notice requirement for non-affiliates and otherwise relax the Form 144 filing requirements.

An issuer with less than US$75m in public float will be eligible to register the sale of its securities (a primary offering) on Form S-3 or F-3 (for foreign private issuers) provided that 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 pursuant to such form in a 12-month period more than the equivalent of one-third of its public float.

These changes are likely to alter the way in which companies evaluate their financing options by increasing the attractiveness of private placements, PIPEs and 144A offerings.

Private placements and PIPEs
In recent years, private placements and PIPEs have become much more important financing alternatives for smaller public companies that may not have ready access to the public markets. Larger public companies that seek to finance quickly or that are fearful that their stock may be shorted upon announcement of a public offering also choose private placements and PIPEs as financing alternatives. One of the principal concerns for issuers seeking to raise money in a private placement or PIPE has been the extent of the ‘liquidity discount’ demanded by investors purchasing the restricted securities and agreeing to bear the risk of holding such securities for the Rule 144 holding period or until a
resale registration statement covering their resale of those securities was declared effective. The Rule 144 changes will reduce the cost to issuers of raising capital through private placements and PIPEs by making restricted securities more liquid, since the required holding period has been shortened. The impact of the increased liquidity is likely to be a reduction in the ‘liquidity discount’ received by investors who purchase securities in private placements or PIPEs.

The changes to Rule 144 also may result in changes to the typical resale registration requirements. In most private placements or PIPEs, the issuer must covenant to file with, and to have declared effective by, the SEC a registration statement covering the resale from time to time by the investors of their restricted securities. Usually, the time periods for filing of, and obtaining effectiveness of, the resale registration statement are the subject of negotiation. In PIPEs, issuers frequently agree to a 60-day or a 90-day period for obtaining effectiveness and associated penalty payment or liquidated damages provisions for the failure to meet these time periods. Certain sector or buy-and-hold investors (assuming they are not ‘affiliates’ of the issuer) may not be as insistent on a resale registration statement. Technical or financial buyers (hedge funds) are likely to continue to request a resale registration statement. However, for issuers, the burden of maintaining the effectiveness of a resale registration statement has been eased. Prior to the amendments, an issuer would have had to covenant to maintain effectiveness of the resale registration until the later to occur of two years, or the date on which the selling security holders could resell the securities without limitation. Now, that period generally will be reduced to one year. In contrast, it may be appropriate in light of the now compressed time periods, for investors to request that the issuer file the resale registration more quickly. One way to look at this may be that any resale registration statement that is unlikely to be declared effective within 45 days of funding adds little value to the transaction and is, therefore, no longer important. The expanded eligibility of a short-form registration statement for smaller public companies may have the ancillary benefit of bringing greater clarity to the SEC’s views regarding the use of a short-form registration statement for secondary sales by issuers with a non-affiliate public float of less than US$75m.
In the case of traditional private placements, investors historically demanded piggy-back registration rights. Given the shortened Rule 144 holding period, investors may not need the piggy-back registration rights.

### 144A offerings

Many issuers, both domestic and foreign, access the US institutional investor market by offering securities in a 144A offering. There are various types of Rule 144A offerings. For example, a private company may choose to offer common stock in a Rule 144A offering as an alternative to, or a precursor to, an IPO. A foreign issuer that is not a reporting company in the US may offer its securities to US investors in a 144A offering. A US reporting company may choose to offer a class of securities, usually debt securities, other than the class that is listed or traded on a securities exchange in a 144A offering. The Rule 144 amendments will reduce the ‘liquidity discount’ associated with all of these 144A offerings, since security holders will now have another, more rapid, means of reselling their securities. For 144A offerings of debt securities, the Rule 144 amendments may result in improved secondary market liquidity and hence better pricing. The Rule 144 amendments eliminated the manner of sale requirements for debt securities, which for this purpose include asset-backed securities and non-participating preferred securities in addition to traditional debt securities. Under existing Rule 144, sales of both debt and equity securities were limited to the greater of 1% of the outstanding class on the average weekly trading volume during any three-month period. Many observed that these limitations effectively precluded the resale of debt securities in reliance upon the rule. Under the amended rule, the volume limitations for debt securities have been increased to 10% of the relevant tranche during any three-month period.

Typically, 144A offerings conducted by US reporting issuers entail registration rights. High-yield and similar offerings of non-convertible debt securities involve an exchange offer (referred to as an Exxon Capital, or A/B, exchange offer), wherein the issuer agrees to register an identical class of securities. Convertible debt offerings under 144A typically involve a commitment on the issuer’s part to file and maintain effective a resale registration statement. For these 144A offerings, issuers generally have had a 180-day or 270-day period during which to obtain effectiveness of the exchange offer or resale registration statement. Given the now reduced six-month Rule 144 holding period for non-affiliates, these registration periods no longer make sense. 144A purchasers other than affiliates of the issuer may rely on the six-month holding period. Market practice is likely to undergo a fair amount of change in respect of 144A offerings. Issuers and initial purchasers will have to agree on a process for legend removal, changes to CUSIP numbers and other mechanics in these offerings.

### Public offerings

Prior to the amendments, an issuer needed a US$75m public equity float in order to use the short-form registration statement form for primary offerings. Under a short-form registration statement, the issuer may incorporate by reference periodic reports filed after the effective date of the registration statement, so there is no need to file post-effective amendments to reflect new business and financial developments. An issuer eligible to use Form S-3 may conduct primary offerings ‘off the shelf’ under Rule 415 under the 1933 Act. Having an effective shelf registration statement provides an issuer with significant flexibility in accessing the market. A prospectus supplement for a specific ‘take down’ off of a shelf registration statement is not subject to SEC review. An issuer also may register various classes of securities, including debt securities.

As a result of these changes, smaller public companies will file ‘kitchen sink’ or ‘universal’ shelf registration statements in order to be able to offer their securities on an opportunistic basis. More smaller public companies will be able to offer equity securities in underwritten or agented shelf take downs. Many smaller public companies had limited financing options. Now, it is likely that smaller public companies will be able to choose among a private placement, a PIPE, or a registered shelf take down. Depending upon market conditions, a registered shelf take down may involve a smaller discount to the market price than a PIPE or a private placement.

Smaller public companies attempting to conduct private placements or PIPEs frequently run into the shareholder approval requirements of the securities exchanges, referred to as the 20% rule. Prior shareholder approval is required for a private placement that is completed at a discount to the issuer’s book value or market price per share, which may result in the issuance of 20% or more of the issuer’s total outstanding capital stock. The shareholder approval requirements often have limited the ability of smaller companies to raise sufficient funds. These requirements do not apply to ‘bona fide’ public offerings. The availability of shelf registration statements will enable more issuers to effect equity offerings without triggering the shareholder approval requirements. Smaller public companies still will be limited in their financing alternatives by the one-third cap on issuances pursuant to the short-form registration statement.
Other changes

IPOs
The changes make some IPO conventional wisdom no longer wisdom. For example, henceforth, all of the securities in a newly public company held by non-affiliates will be released from the dribble-out rules. This, in turn, may impact the overall length of lock-up periods. The traditional 180-day lock-up period for IPOs and 90-day lock-up period for follow-on offerings may need to be reconsidered. This is also likely to shift the dynamics of follow-on offerings. Non-affiliates will no longer need a registration statement after holding for a year in order to sell a significant block of stock. Therefore, getting them to agree to a lock up may become considerably more difficult.

Stock as acquisition consideration
The SEC also amended Rule 145, which provides that exchanges of securities in connection with reclassifications of securities, mergers or consolidations, or asset transfers subject to a shareholder vote, constitute sales of securities. Prior to the amendments, Rule 145(c) deemed a person who is a party to these transactions (other than the issuer, or any person who is an affiliate of the issuer when the transaction is submitted for vote or consent) and who publicly offers or sells securities of the issuer acquired in connection with the transaction to be an ‘underwriter’. The amendments eliminated this presumptive underwriter concept, except in the case of transactions involving shell companies. As a result, affiliates of a target company who receive shares in a Rule 145 business combination and who do not become affiliates of the acquirer will be able to immediately resell the securities freely, without a registration statement. Restricted securities issued in an acquisition (structured as a private placement) will be subject to the shorter Rule 144 holding period also improving the value of restricted stock as acquisition currency.

Conclusion
The SEC rule revisions should have far-reaching effects on capital formation in the US. While the initial impetus to adopt the reforms may have come from an interest in seeing smaller public companies gain enhanced access to our capital markets, these reforms, as implemented, have created financing flexibility and improved capital markets access for large and small public companies alike. Thus far, no presidential candidate has claimed credit for this initiative. But, the year is young, the election is nine months away, and they have had other things on their minds….

Authors:
Anna T. Pinedo, Partner, and
James R. Tanenbaum, Partner and Chair
Global Capital Markets Practice
Morrison & Foerster LLP
1290 Avenue of the Americas
New York
NY 10104
US
Tel: +1 212 468 8179 / +1 212 468 8163
Fax: +1 212 468 7900
Email: apinedo@mofo.com
jtanenbaum@mofo.com
www.mofo.com