

The SEC's December 2007 Rule Revisions: Updates to Standard Transaction Documentation for Financial Intermediaries (Part 2)

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(This is the second of a two-part series of articles discussing the SEC's revisions to Rule 144, Forms S-3 and F-3, and reporting requirements for smaller companies. The first part of this series was published in our April issue.)

In December 2007, the SEC released the final versions of important rule revisions relating to Rule 144, Form S-3/F-3 eligibility, and the reporting requirements of "smaller reporting companies."

This two-part series is principally intended to alert financial intermediaries to some of the changes that they might consider making to their principal standard transaction documents and forms as a result of these amendments. As to a variety of these provisions, we set forth proposed revised language and provisions, which are indicated with marked text.

In last month's article, we summarized these amendments, and discussed potential revisions to underwriting agreements, placement agency agreements and related

offering documents. In this issue, we will discuss potential changes to registration rights agreements and related provisions in PIPEs and other private placements, and we will also discuss documentation changes in connection with sales of Rule 144 "restricted securities" and broker-dealer compliance manuals.

Revisions to Registration Rights Agreements and Related Provisions in PIPEs and Other Private Placements

Effectiveness of Registration Statement — To date, a standard covenant for maintaining the effectiveness of a re-

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sale registration statement for restricted securities held by non-affiliates of the issuer would have been to maintain the effectiveness of the registration statement until the later to occur of either two years, or 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, particularly in cases where none of the investors in the financing will be affiliates of the issuer after the closing. (However, affiliated investors will likely demand retain registration rights for as long as they remain affiliates.)

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, which will enable non-affiliates to sell restricted shares of reporting companies without regard to the current information requirements after a one-year holding period, this period may also be reduced to one year for these investors.

Liquidated Damages—Timing and Amounts — Registration rights agreements for restricted securities typically impose cash penalties on an issuer for failing to file a resale registration statement or to cause the registration statement to be declared effective after stipulated “deadlines” have passed. Penalties may also be imposed if the registration statement does not remain effective, except under certain specified circumstances and for agreed-upon periods of time. 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 been imposed under the prior rules?

The factors to be considered 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;
- whether having an effective registration statement will make it easier for the issuer to cause its transfer agent to remove any restrictive legends from the applicable securities¹;
- whether the issuer has any known existing disincentive to diligently prepare and process the registration statement.

In recent years, it has been common for issuers to be required to have the resale registration statement declared effective 60 or 90 days after the closing date of the private placement. Because of the new six-month holding period, if an issuer cannot cause its resale registration statement to be declared effective within that period, the incremental value of the registration statement may be reduced for non-affiliated investors in the private placement; there will be a shorter period of time after the deadline in which these investors will be restricted from selling the securities under amended Rule 144.

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 remove its volume limitations, these rights are likely to be less appropriate or helpful 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 and that the holder has complied with its prospectus delivery obligation; 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. As noted above, such sales will be subject to the Rule 144 current information requirements until the expiration of a one-year holding period. Accordingly, it is possible that such new legend-removal provisions may apply after a one-year period. The one-year period would help prevent violations of Rule 144 resulting from the fact that the relevant issuer was no longer in compliance with the current information requirement.

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.² Placement agents benefit from this position: if they receive warrants as compensation for effecting a private placement or for providing other financial advisory services, then, even if the issuer does not register the underlying shares, they may begin to exercise the warrants and sell the underlying shares six months after the closing. Accordingly, placement agents should review their forms to confirm that the brokers' warrants received as compensation in private capital-raising transactions or for providing other financial advisory services include a cashless exercise provision. In this regard, we also note that Rule 144 permits tacking if the cashless exercise feature is added to the warrants after their initial issuance date. Accordingly, when feasible, placement agents may seek to amend their existing brokers' warrants from prior transactions to add this term.

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

Rule 144A offerings of debt securities issued 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 even 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 the declaration of effectiveness of a registration statement that is typically set forth in the registration rights agreements. 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 one year (due to the current information requirement of Rule 144), after the closing date.³

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, and made subject to Rule 144's volume limita-

tions for affiliated securityholders, in order to ensure compliance with the rule. 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
- to 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.

In addition, to help ensure that the investors will be entitled to effect resales under Rule 144 after six months have expired from the closing date, but before one year has expired, it may be appropriate to add one or more penalty provisions (similar to penalties arising from a failure to register securities) if the issuer is not in compliance with the current public information requirement.

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 unlegended 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 need to be included in 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 issuer's transfer agent with representation letters establishing that the sale was made in compliance with Rule 144. Typically, brokers will have mul-

iple 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 the securities 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 will require revision. In addition to the changes described in the text box below:

- representation letters with respect to sales of restricted securities by affiliates of a reporting issuer should be revised to reflect the new six-month holding period; and
- representation letters under former Rule 144(k), which enabled unlimited resales by non-affiliates of a reporting issuer after a two-year holding period, should be revised to reflect the new six-month holding period provided by Rule 144(b)(1)(i).

Revisions to Compliance Manuals Relating to Rule 144 Sales

The relevant provisions of each broker-dealer's compliance manual or 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.⁴

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;⁵
- 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;⁶

- Rule 144 is not available for the resale of securities issued by companies that are, or previously were, blank check companies;⁷ 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.⁸

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. The codification of these interpretations should remove any lingering uncertainty.

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 article and last month's article. We hope that these articles have helped prepare readers for the transactions they encounter, and the new provisions they will prepare, negotiate and ultimately, perform.

NOTES

1. Please see the discussion below, under the caption "—Provisions for Removing Restrictive Legends."
2. Amended Rule 144(d)(3)(x). Similar "tacking" is permitted in the case of convertible preferred stock or convertible debt securities.
3. Due to applicable contractual and legal restrictions relating to their permitted investments, a variety of institutional investors may need to have these securities registered under the Securities Act, notwithstanding the recent amendments to Rule 144. Accordingly, investor requirements and preferences are likely to impact actual developments in the documentation for these transactions.
4. See Amended Rule 144(h)(1).
5. Amended Rule 144(d)(3)(ix).
6. Amended Rule 144(e)(3)(ii).
7. See Amended Rule 144(i)(1)(i).
8. Amended Form 144.