SULLIVAN & CROMWELL LLP

January 15, 2021

SEC Proposes Amendments to Rule 144 Holding Period and Form 144 Filings

Proposal Would Eliminate “Tacking” for Securities Acquired Upon the Conversion or Exchange of Certain Market-Adjustable Securities of Unlisted Issuers and Amend the Form 144 Filing Requirements

SUMMARY

On December 22, 2020, the Securities and Exchange Commission (the “SEC”) proposed to amend Rule 144 to change the holding period determination for securities acquired upon the conversion or exchange of certain market-adjustable securities for unlisted companies so that the holding period would not begin until the conversion or exchange.[1] The proposal also includes several other amendments relating to Form 144, including:

- Requiring electronic filing of Form 144 for securities of issuers subject to Exchange Act reporting;
- Eliminating the requirement to file a Form 144 for securities of issuers that are not subject to Exchange Act reporting; and
- Amending the filing deadline for Form 144 to coincide with the Form 4 filing deadline.

Comments on the proposal are due 60 days after the proposal is published in the Federal Register.

HOLDING PERIOD FOR CERTAIN MARKET-ADJUSTABLE SECURITIES

Rule 144 provides a non-exclusive safe harbor from the statutory definition of “underwriter” to assist security holders in determining whether the Section 4(a)(1) exemption is available for their resale of restricted or control securities. A condition of Rule 144 for restricted securities is that a selling security holder must have held the securities for a specified period of time prior to resale, which is designed to help ensure that the

holder has assumed the full economic risks of investment and is not acting as a conduit on behalf of the issuer or an affiliate for the sale of securities to the public.

For purposes of the Rule 144 holding period requirement, Rule 144(d)(3)(ii) currently provides that if securities sold were "acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the securities surrendered for conversion or exchange." The proposed amendment amends the holding period for securities acquired upon the conversion or exchange of certain market-adjustable securities of an unlisted issuer so that the holding period would not begin until conversion or exchange. Under the proposed amendment, a market-adjustable security is a "convertible or exchangeable security [that] contains terms, such as conversion rate or price adjustments, that offset, in whole or in part, declines in the market value of the underlying securities occurring prior to conversion or exchange, other than terms that adjust for stock splits, dividends, or other issuer-initiated changes in its capitalization."

Therefore, the proposed amendment would not allow for tacking of the holding period of the market-adjustable security prior to conversion or exchange in order to establish the applicable Rule 144 holding period for the underlying security following conversion or exchange. However, the proposal does not apply to most convertible or variable-rate securities transactions as it would only apply where:

- The newly acquired securities were acquired from an issuer that, at the time of the conversion or exchange, does not have a class of securities listed, or approved for listing, on a national securities exchange registered pursuant to Section 6 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and
- The convertible or exchangeable security contains terms, such as conversion rate or price adjustments, that offset, in whole or in part, declines in the market value of the underlying securities occurring prior to conversion or exchange, other than terms that adjust for stock splits, dividends, or other issuer-initiated changes in its capitalization.

In the proposed amendment, the SEC notes that the current Rule 144 incentivizes holders of certain market-adjustable securities to convert at discounted conversion rates and promptly resell the underlying securities into the market, thereby securing the profit from the discounted rate and avoiding most pre-conversion market risk. Thus, some holders can satisfy the holding period of Rule 144 while purchasing with a view to distribution. Accordingly, the goal of the proposal is to "mitigate the risk of unregistered distributions" with respect to the sales of the securities underlying market-adjustable securities.

In deciding to limit the proposed amendment to unlisted issuers, the SEC focused on the fact that national securities exchanges "have certain listing requirements, such as requiring shareholder approval of an issuance of 20 percent or more of a company's common stock." The SEC explained that "[b]ecause market-adjustable securities have the potential to result in highly dilutive issuances of large amounts of the issuer's securities, these required approvals are not likely to be granted in the situations that the amendment is intended to address."[2] The SEC, however, seeks comment on whether the proposal should be limited to unlisted issuers.

The definition of market-adjustable security includes any term that provides price protection "in whole or in part." The examples given by the SEC in the proposing release relate to market-adjustable securities that offset the market risk in whole. It is unclear how "in part" should be interpreted since it would appear to encompass adjustable securities that provide just partial protection against a decline in an issuer's stock price. This would not seem consistent with the examples given, and the concerns raised by the SEC, in the proposing release.

The definition of market-adjustable security excludes anti-dilution adjustments such as stock splits, dividends, or other issuer-initiated changes in capitalization. It is unclear exactly how broad this anti-dilution exclusion is. For example, the exclusion could be viewed as not being available for adjustments as a result of actions by affiliates or third parties that affect an issuer's capitalization, such as conversions of high vote shares into low vote shares by affiliates or founders. It is also unclear whether the exclusion would cover anti-dilution adjustments triggered by the issuance of securities below the conversion or market price.

FORM 144 AMENDMENTS

The proposal also includes several other amendments related to Form 144 including:

- Mandating the electronic filing of Form 144 via EDGAR, whether or not the filing person is subject to Section 16 of the Exchange Act;[3]
- Eliminating the Form 144 filing requirement related to the sale of securities of issuers that are not subject to the reporting requirements of the Exchange Act;
- Amending the Form 144 filing deadline to coincide with the Form 4 deadline (i.e., within two business days following the day on which the sale of securities has been executed or the deemed date of execution);
- Requiring disclosure of the total sale proceeds for completed sales rather than the aggregate market value of proposed sales;
- Eliminating the Form 144 disclosure requirements to provide the seller's address and the issuer's IRS identification number; and
- Eliminating the requirement to send one copy of the Form 144 to the principal securities exchange on which the restricted securities are admitted to trading.[4]

Forms 144 submitted as paper filings are often not publicly available until significantly after the execution of the transaction, either through the SEC's public reference or through third-party information services. Consequently, the electronic filing mandate may give more publicity to affiliate sales, particularly for affiliates of foreign private issuers who are not subject to reporting under Section 16 of the Exchange Act and therefore may not have otherwise made an EDGAR filing with respect to the transaction.

In addition, the SEC intends to make Form 144 available online as a fillable document and modify EDGAR to provide filers with the option to file a Form 144 and a Form 4 through a single user interface. The proposal includes a six-month transition period to allow first-time electronic filers time to apply for codes to make filings in EDGAR.

REQUEST FOR COMMENT

The SEC makes a broad request for comment on the proposals. Among other matters, the SEC requests comment on:

- Whether the holding period of market-adjustable securities should be extended to one year;
- Whether Form 144 should be eliminated; and
- Whether, if Form 144 is retained, other disclosures required by Form 144 should be eliminated.

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ENDNOTES

1 *SEC Proposes Amendments to Rule 144 and Form 144* (Dec. 22, 2020), https://www.sec.gov/news/press-release/2020-336.

2 The SEC also noted that listed issuers "have generally not been engaging in these transactions."

3 In response to COVID-19, the SEC is currently allowing filers to submit Form 144 by emailing a complete PDF attachment to the SEC. Though the Division of Corporation Finance has indefinitely extended its recommendation not to enforce paper filing of Form 144 as long as filers submit by email, the proposed amendment would require electronic filing via EDGAR.

4 The proposal also includes amending Forms 4 and 5 to add an optional check box to indicate that a reported transaction was made pursuant to a Rule 10b5-1 plan.

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