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Congress Creates New Exemption for Private Resales of Securities

New Securities Act Section 4(a)(7) Exempts the Resale of Restricted and Control Securities to Accredited Investors from the Registration Requirements of Section 5 of the Securities Act

INTRODUCTION

Last Friday, President Obama signed into law the Fixing America's Surface Transportation Act (the "FAST Act"). Although the FAST Act deals primarily with transportation funding, it also amends the Securities Act of 1933 (the "Securities Act") to add a new exemption from the registration requirements for private resales of "restricted" and "control" securities to "accredited investors." This new exemption will significantly facilitate resales of such securities. The FAST Act also includes other amendments to the federal securities laws described below. These changes were effective immediately.

NEW EXEMPTION FROM THE SECTION 5 REGISTRATION REQUIREMENTS

The FAST Act amends the Securities Act to add a new Section 4(a)(7), which exempts from the registration requirements of Section 5 of the Securities Act resale transactions meeting the following requirements:

- The seller is not the issuer or a direct or indirect subsidiary of the issuer of the relevant securities.
- Each purchaser of the securities is an "accredited investor," as defined in Securities Act Rule 501(a).
- Neither the seller, nor any person acting on the seller's behalf, offers or sells the securities by any form of general solicitation or general advertising.
- The securities are of a class that has been authorized and outstanding for at least 90 days prior to the date of the transaction.
- The securities are not part of an unsold allotment to, or a subscription or participation by, a broker or dealer as an underwriter or a redistribution.

- Neither the seller, nor any person remunerated for offering or selling the securities, is subject to a "bad actor" disqualification under Rule 506(d)(1) of Regulation D under the Securities Act or a statutory disqualification under Section 3(a)(39) of the Securities Exchange Act of 1934 (the "Exchange Act").
- Resales of securities of non-reporting issuers – issuers that are neither subject to the reporting requirements of Sections 13 or 15(d) of the Exchange Act, nor foreign private issuers exempt from reporting pursuant to Rule 12g3-(b) thereunder, nor foreign governments eligible to register securities under Schedule B of the Securities Act – must comply with an additional information requirement. The seller and a prospective purchaser must obtain from the issuer, upon request of the seller, and the seller must make available to the prospective purchaser, reasonably current specified information about the issuer, including:
  - the nature of the issuer's business, products and services;
  - the names of its officers and directors;
  - the name of any registered broker, dealer or agent being remunerated for participating in the offering;
  - the issuer's most recent balance sheet and profit and loss statement for such part of the two preceding fiscal years as it has been in operation, prepared in accordance with U.S. generally accepted accounting principles (or, in the case of a foreign private issuer, International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board); and
  - if the seller "controls" the issuer, a brief statement regarding the nature of the affiliation, and a statement certified by the seller that it has no reasonable grounds to believe that the issuer is in violation of the securities laws or regulations.

The new exemption applies to purchases by "accredited investors," as defined in Securities Act Rule 501(a). The Rule 501(a) definition covers persons that satisfy certain criteria, or that "*the issuer reasonably believes"* satisfies those criteria. Since the issuer will not be involved in Section 4(a)(7) transactions, one interpretive question is whether the reasonable belief standard will nonetheless apply; the better reading would seem to be that it should.

Section 4(a)(7) is not available for securities of certain issuers that are dormant, bankrupt or shell companies.[1] The FAST Act also provides that any Section 4(a)(7) transaction will be deemed not to be a distribution for purposes of Section 2(a)(11) of the Securities Act, and that securities acquired in such a transaction will be deemed to have been acquired in a transaction not involving any public offering and thus to be "restricted securities" within the meaning of Rule 144 under the Securities Act. In addition, securities sold in a Section 4(a)(7) transaction are "covered securities" for purposes of the provisions of Securities Act Section 18, which preempts the registration requirements of state securities laws.

Finally, the FAST Act makes it clear that the Section 4(a)(7) exemption is not exclusive of other available exemptions.

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[1] The issuer must be engaged in business, not be in the organizational stage or in bankruptcy or receivership and not be a blank check, blind pool or shell company that has no specific business plan or purpose, or have indicated that its primary business plan is to engage in a merger or combination of its business with, or an acquisition of, an unidentified person.

IMPLICATIONS OF NEW EXEMPTION

The implications of the new Section 4(a)(7) exemption for resales of "restricted securities" and the private placement market are significant. Assessing those implications requires an understanding of current practices for resales of securities issued in transactions not registered with the SEC.

Section 5 of the Securities Act generally requires that a sale of a security be registered with the SEC, unless an exemption is available. The primary exemption for initial sales is Section 4(a)(2), which permits sales by issuers in transactions not involving a public offering. After a security is acquired in a private placement, it is considered a "restricted security." The primary exemption for resales of securities is Section 4(a)(1), which permits sales of securities by persons who are not issuers, underwriters or dealers. Section 2(a)(11) defines "underwriter" broadly to include any person who purchases a security from an issuer or an affiliate of the issuer with a view to, or in connection with, a distribution. "Distribution" has itself been broadly interpreted in this context to mean any offering that is not a private offering. The broad and somewhat uncertain definitions of "underwriter" and "distribution" generally operate to substantially restrict the ability of purchasers of securities in private placements to resell or hedge those securities. In addition, purchasers in private placements are often required by the issuer contractually to restrict their resales. Issuers are incentivized to obtain these contractual commitments because issuers may be held responsible for subsequent transactions that violate Section 5 even though the issuer did not participate in those transactions.

To address some of the uncertainty around whether a sale of "restricted securities" complies with Section 5, the SEC has adopted two key safe harbor rules permitting resales of securities issued in unregistered offerings, Rule 144 and Rule 144A. Rule 144 permits resales by non-affiliates of "restricted securities" that have been outstanding for six months (if the issuer is a current reporting company) or one year (in all other cases). Rule 144 also permits sales of securities by affiliates of the issuer, subject to limitations on the amount sold and the manner of sale, whether or not the control securities are also "restricted securities." Securities sold in a Rule 144 transaction are no longer "restricted securities" in the hands of the purchaser. Rule 144A provides a safe harbor from the registration requirements for resales of securities to "qualified institutional buyers," or QIBs. However, Rule 144A is not available for securities that were, when issued, fungible with listed securities, such as the common stock of most reporting companies. "Restricted securities" sold in a Rule 144A transaction remain restricted in the hands of the purchaser.

In circumstances where a safe harbor rule is not available, resales of "restricted securities" may be effected under the so-called "Section 4(a)(1½) exemption," a reasoned set of procedures for resale transactions that embody the hallmarks of an issuer private placement pursuant to the Section 4(a)(2) exemption. Specifically, under market practice developed over many years, Section 4(a)(1½) transactions may not involve any general advertising or general solicitation and are typically individually

negotiated with a small number of purchasers who provide specific representations as to their sophistication, access to information and non-distributive intent.

We expect new Section 4(a)(7) largely to supplant and, as discussed below, be available in a broader range of circumstances than the Section 4(a)(1½) procedures for resale transactions that do not fall within the safe harbors provided by Rule 144 or Rule 144A.

New Exemption Compared with "Section 4(a)(1½)"

For securities of reporting companies or Rule 12g3-2(b) filers, the requirements of the new exemption significantly simplify the analysis otherwise required in connection with Section 4(a)(1½) transactions. For example, under the Section 4(a)(7) exemption, a seller need only be concerned with general solicitation or general advertising undertaken by it or those acting on its behalf, whereas in a Section 4(a)(1½) transaction, selling activity or publicity by the issuer or other sellers of securities could arguably cause the transaction to be deemed a public offering, rendering the exemption unavailable.[2]

In addition, there is no information requirement for reporting issuers and Rule 12g3-2(b) filers. In fact, provided that the issuer is an operating company and securities of the relevant class have been outstanding for 90 days, all a seller need ensure is that the purchaser is an "accredited investor" and that neither the seller nor anyone acting on its behalf is a "bad actor" or has engaged in general advertising or general solicitation. On the other hand, the use of the new exemption for resales of securities issued by non-reporting issuers is conditioned on the seller providing certain specified information about the issuer, making it less clear whether the Section 4(a)(7) exemption will be much of an improvement on Section 4(a)(1½) transactions for resales of securities of non-reporting issuers.

New Exemption Compared with Rule 144 and Rule 144A

The new exemption does not have the holding periods or, for sales by affiliates, amount and manner of sale restrictions contained in Rule 144. In addition, although Section 4(a)(7) requires that the relevant class of securities (as opposed to the actual securities being resold) have been outstanding for at least 90 days, this condition will ordinarily be satisfied.

In particular, control persons and other affiliates of an issuer will benefit from being able to sell securities of the issuer in excess of the Rule 144 volume restrictions, and Section 4(a)(7) sales will not reduce the amount otherwise available to be sold under Rule 144. As a result, Section 4(a)(7) may provide a significant alternative source of liquidity for affiliated resellers, although it remains to be seen whether and the extent to which buyers will demand a discount for securities sold in such transactions relative to Rule 144 transactions and the public markets.

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[2] Media publicity has also raised concerns for Section 4(a)(1½) transactions, but generally should not be an issue under Section 4(a)(7) as long as such publicity is not attributable to the seller or those acting on its behalf.

It is unclear to what extent new Section 4(a)(7) will move transactions out of the Rule 144 market, and whether marketplaces will develop to facilitate trading among "accredited investors" under Section 4(a)(7). We would expect the greatest benefits to be for affiliates that are subject to Rule 144's volume and manner of sale limitations. However, non-affiliate holders of "restricted securities" may find that Section 4(a)(7) increases the liquidity for "restricted securities" prior to the expiration of the applicable six-month or one-year holding period.

We also expect new Section 4(a)(7) to impact the market for hedging transactions with respect to privately placed securities and securities held by affiliates, since the ability to make outright sales will be greater. Moreover, Section 4(a)(7) does not require any minimum holding period before an investor may resell privately placed securities.

However, because securities sold in Section 4(a)(7) transactions will be "restricted securities" for purposes of Rule 144 (and thus could only be further resold in a Section 4(a)(7) transaction, or pursuant to one of the safe harbor rules or another available exemption), whereas securities sold pursuant to Rule 144 are unrestricted, Rule 144 generally may be preferable for resales by affiliated sellers of amounts up to the volume limitations, and for non-affiliated sellers if the sale of "restricted securities" is made after the applicable Rule 144 holding period.

The new exemption is available for sales to "accredited investors," rather than Rule 144A's narrower category of "qualified institutional buyers." While this may not represent a substantial advantage in the case of institutional fixed income trading, it may be very significant in the context of public equity markets.

Section 4(a)(7) would not be available for use in an original offering, in the style of a Rule 144A offering involving immediate resales by dealers of securities privately purchased directly from an issuer, because Section 4(a)(7) transactions may not involve securities that are an unsold allotment of a broker or dealer, and the requirement that the class of securities have been outstanding for 90 days.

Additional Points of Interest

Because the new provisions specify that a transaction under Section 4(a)(7) is deemed not to be a distribution for purposes of Section 2(a)(11), we believe that resale restrictions in private placement documentation could now generally be amended to add Section 4(a)(7) transactions to the litany of permitted resales.

In addition, because the FAST Act also revises Section 18(b)(4) of the Securities Act to specify that a security sold in a Section 4(a)(7) transaction is a "covered security," the registration requirements of state Blue Sky laws will be preempted with respect to securities sold in such transactions.

Finally, depending on how issuers address various issues, including the information requirements of Section 4(a)(7) and limits on the number of security holders an issuer may have before it is required to file

Exchange Act reports, Section 4(a)(7) may facilitate an expansion of pre-IPO transactions in "restricted securities."

OTHER AMENDMENTS TO THE FEDERAL SECURITIES LAWS

The other amendments to the federal securities laws enacted by the FAST Act include:

Emerging Growth Companies

- Shortening from 21 to 15 days the period between the date on which an emerging growth company ("EGC") publicly files the draft registration statement previously submitted for confidential SEC staff review and the date it may commence a road show.
- Providing that an issuer that was an EGC at the time it submitted a draft registration statement for confidential review, but thereafter ceases to be an EGC, will continue to qualify as an EGC for purposes of the SEC's confidential review until the earlier of the date it commences its initial public offering and one year after it ceases to be an EGC.
- Permitting the exclusion from registration statements on Forms S-1 and F-1 filed prior to an initial public offering of historical financial information otherwise required by Regulation S-X at the time of such filing if the issuer reasonably believes such information will not be required at the time of the contemplated offering, and directing the SEC to revise Forms S-1 and F-1 accordingly. For example, an IPO registration statement may be filed without including the earliest year's statements of income and cash flows if the financial statements will be supplemented with the most recent year's information prior to the contemplated offering.

Disclosure Modernization and Simplification

- Directing the SEC to:
  - permit issuers to include a summary page in Form 10-K filings if that page includes appropriate cross-references to other parts of the Form 10-K;
  - revise Regulation S-K to further scale or eliminate requirements in order to reduce the burden on issuers while still providing all material information to investors, and to eliminate provisions of Regulation S-K that are duplicative, overlapping, outdated or unnecessary; and
  - undertake a study of Regulation S-K to determine how best to modernize and simplify its requirements, including with respect to methods of delivery and presentation, so as to make disclosure more relevant and less repetitious; to report to Congress on its findings and any recommendations within 360 days; and to issue proposed rules to implement those recommendations within 360 days after issuing the report.

Small Company Simplified Registration

- Directing the SEC to revise Form S-1 to permit "smaller reporting companies" to incorporate by reference documents filed after the effective date of the registration statement.

Savings and Loan Holding Companies

- Providing that savings and loan holding companies will have the same higher registration and deregistration thresholds as banks under Sections 12(g)(1), 12(g)(4) and 15(d) of the Exchange Act.

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