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Legal Update

Proposed Amendments to Rule 144

In its 2019 Concept Release on Harmonization of Securities Offerings,[1] the US Securities and Exchange Commission (SEC) included a section requesting comment regarding resale exemptions, including Rule 144. While the SEC addressed a number of the key issues relating to the exempt offering framework that were first identified in the Concept Release in a rulemaking earlier this year,[2] the SEC had not until recently addressed any of the resale exemptions. On December 22, 2020, the SEC proposed amendments to Rule 144 and Form 144 (the Proposing Release).[3] In the Proposing Release, the SEC is proposing to amend Rule 144, Form 144, Form 4, Form 5 and Rule 101 of Regulation S-T. We summarize below the principal aspects of the proposed amendments.

The Rule 144 Holding Period Requirement in the Case of Certain Market-Adjustable Securities

The SEC proposes to amend Rule 144(d)(3)(ii) in order to revise the holding period for securities that are acquired upon the conversion or exchange of certain market-adjustable securities of an issuer that does not have a class of securities listed, or approved to be listed, on a national securities exchange (referred to as an "unlisted issuer"). The holding period would not begin until the conversion or exchange, so there would be no "tacking" back to the date of acquisition of the convertible or exchangeable security for market-adjustable securities. Market-adjustable securities are those that have a conversion rate or conversion price that offsets in whole or in part declines in the value of the underlying security that may occur prior to conversion or exchange. The Proposing Release states that the change is being contemplated to mitigate the risk of unregistered distributions in connection with the sale of these securities. Effectively, this change, if adopted would bring back the concept of "tolling" the holding period under Rule 144—reintroducing the concept of tolling the holding period under Rule 144 has been considered at various times and rejected.

In the Proposing Release, the SEC draws distinctions between typical convertible securities and market-adjustable securities. According to the Proposing Release, a holder of a typical convertible security is at substantial economic risk upon conversion with respect to the underlying security if the underlying security fails to appreciate or declines in value. The Proposing Release distinguishes this from market-adjustable securities transactions wherein the conversion or exchange price and/or the amount of securities received on conversion are not fixed at the time of the initial transaction. The Proposing Release goes on to note that initial purchasers or subsequent holders have an incentive to purchase market-adjustable securities

with a view to distribution of the underlying securities following conversion in order to capture the difference between the built-in discount and the market value of the underlying securities. As a result, the holder may be purchasing with a view to a distribution and acting as an "underwriter" and therefore should be unable to rely on the Section 4(a)(1) exemption from registration.

The SEC proposes to amend Rule 144(d)(3)(ii) to provide that the holding period for the securities acquired upon conversion or exchange of certain market-adjustable securities issued by unlisted issuers would not begin until conversion or exchange. The proposed amendment is limited to unlisted issuers, according to the Proposing Release, because the securities exchanges already have addressed this issue through their shareholder approval rules for listed companies.

All in all, in our view, this seems like a problematic approach. The securities exchanges have indeed addressed the issues posed by the dilutive effect of future-priced securities through their shareholder approval rules. While the shareholder approval rule addresses dilution, it does not address whether a purported purchaser in a private placement has investment intent at the time of purchase manifested by the assumption of risk. The purpose of the shareholder approval rule is not to determine whether there is a valid private placement, or whether instead the purchaser should be viewed as an "underwriter" because the purchaser never took the risk of ownership of the security. Shouldn't there be a consistent approach to the issue regardless of whether the securities exchanges have tackled the dilution issue?

The Proposing Release does not question whether there was a valid private placement if one were to conclude that the purchaser lacked investment intent and was acting as an underwriter. Nor does the Proposing Release consider any of the issues that were raised when the SEC previously considered tolling the Rule 144 holding period in other instances, including where a holder that purchased in a valid private placement and with no view to effecting a distribution had entered into countervailing hedging arrangements. In the case of a death spiral convertible (where a bond converts into a set value paid in shares, causing share price to drop as more bonds convert), there might be an enforcement solution to the problem, rather than reopening the Rule 144 tolling debate. For instance, the SEC has the ability to bring a claim of market manipulation if the facts support it. In addition, where there appears to be an abuse of the Rule 144 safe harbor such that the purchaser is technically in compliance with the Rule, but appears to be engaged in the business of buying and selling securities, the SEC could bring an action against the purchaser for failing to register as a broker or dealer under the Securities Exchange Act of 1934 (Exchange Act). Mitigating the risk of unregistered distributions is a valid public policy objective. However, tackling the problem with this proposed amendment muddies the approach to the Rule 144 holding period and raises fundamental issues that were asked and answered in connection with prior amendments to Rule 144.[4] Moreover, the SEC Staff has provided guidance on equity line of credit arrangements, which often involve market-adjustable securities, and could have addressed these issues in that context.[5]

Proposed Amendments to the Form 144 Filing Requirements

Proposed amendments to Rule 101 would mandate electronic filing of all Form 144 notices for Rule 144 resales of the securities of issuers that are subject to the reporting requirements of Section 13 or Section 15(d) of the Exchange Act, and eliminate the paper filing option. (Although some filers may miss the flexibility to make paper Form 144 filings, EDGAR filers have the advantage of being allowed to use the SEC's recent electronic signatures procedures).

A Form 144 filer who has not previously made an electronic filing on EDGAR would need to apply for EDGAR access in order to make Form 144 filings in the future. However, the proposed amendments would eliminate the filing requirement for Form 144 notices for resales of securities by affiliates of issuers that are not subject to Exchange Act reporting requirements.

Rule 144(h)(1) would also be amended to delete the requirement that an affiliate send one copy of the Form 144 notice to the principal exchange, if any, on which the restricted securities are admitted to trading.

In addition, the proposed amendments would eliminate two unnecessary data fields and create an online fillable document for entering the information required by Form 144.

The amendments also are intended to streamline the electronic filing process for those filing both a Form 144 and a Form 4 to report the same sale of equity securities. The Form 144 filing deadline would be amended to coincide with the Form 4 filing deadline. Rule 144(h)(2) would be revised to require that a Form 144 be filed before the end of the second business day following the day on which the sale of securities has been executed or the deemed date of execution rather than have it due concurrently with either the placing of an order with a broker to execute the sale or the execution of a sale directly with a market maker, as currently required. The proposed amendment to the Form 144 filing deadline would facilitate this new filing process. This filing deadline would apply to all Forms 144, regardless of whether a Form 4 also needs to be filed for the same transaction. The proposal therefore would provide all Form 144 filers more time to file the form.

Finally, the SEC proposes to allow Form 4 and Form 5 filers, at their discretion, to include a check box to indicate that a sale or purchase of securities was made pursuant to Rule 10b5-1(c).

The proposed amendments are subject to a 60-day comment period following publication of the Proposing Release in the *Federal Register*.

For more information about topics raised in this Legal Update, please contact any of the lawyers listed below.

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ENDNOTES

[1] https://www.sec.gov/rules/concept/2019/33-10649.pdf.

[2] https://www.sec.gov/rules/final/2020/33-10844.pdf.

[3] https://www.sec.gov/rules/proposed/2020/33-10911.pdf

[4] In 1990, the SEC amended Rule 144 and eliminated the tolling of the holding period if the holder had engaged in short sales, puts or other options to sell securities, which transactions had raised questions regarding whether the holder had requisite investment intent in respect of the restricted securities it held as it was attempting to mitigate the market risk associated with such securities. In 1995 and again in 1997, the SEC solicited comments in connection with proposed amendments to Rule 144 as to whether to reintroduce tolling of the Rule 144 holding period in connection with hedging transactions or other similar transactions that were intended to mitigate the market risk associated with holding a restricted stock position. The SEC, responding to comments, and considering the proliferation of hedging techniques and the desire to simplify and modernize Rule 144, decided against reintroducing the tolling concept. Instead, the SEC determined that it would watch for abusive or manipulative practices and address these particular problematic practices.

[5] *See*, for example, in the context of equity lines of credit, Compliance and Disclosure Interpretations, Securities Act Sections, 139.12, 139.13, 139.14, and 139.21-24, available at https://www.sec.gov/corpfin/securities-act-sections#139-13.