RESALES OF RESTRICTED SECURITIES: DEAL POINTS

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Executive Summary

Securities issued pursuant to most of the exemptions from public registration pursuant to section 5 of the U.S. Securities Act of 1933, as amended (the "Securities Act") are in most cases "Restricted Securities," which may not be resold freely like securities issued in an initial public offering, or "IPO," that have been listed on a securities exchange. For example, securities issued pursuant to the most frequently used Securities Act exemption, Regulation D, are Restricted Securities. Regulation A, a section 5 registration-exempt offering method, is an exception; securities issued under Reg. A are not restricted from resale, because Reg. A is itself a quasi-public offering, although not pursuant to section 5 (for discussions of how to use Reg. D, Reg. A, Reg. S and other exemptions, their advantages and disadvantages, see our "Raising Capital through Private Placements: Deal Points" ("Raising Capital"), available at Kurtin PLLC - Raising Capital or by request to Kurtin PLLC Publications). Securities issued under as Securities Act exemptions may be registered under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and then freely resold. However, just as for initial issuance of securities, there are Securities Act exemptions that permit resale of Restricted Securities without registration under the Exchange Act, and which therefore provide liquidity to holders of those securities, and generally make the securities more valuable, raising their market price, to the benefit of both the reselling security holder and, indirectly, the issuing company. This advisory will canvas the principal resale exemptions.

I. Principal Resale Exemptions

a. Rule 144: Securities Act Rule 144 contains the definition of Restricted Securities: securities acquired from the issuer ("Issuer") or its affiliate in a transaction or chain of transactions not involving a public offering, and specifically includes securities received from the Issuer in offerings conducted under Reg. D, Rule 701, Reg. CE, Reg. S, and Rules 801 and 802 (all covered in "Raising Capital"). Restricted Securities cannot be resold unless they are subsequently registered or unless another exemption from registration is available for their resale. The most frequently used resale exemptions are found under Rule 144, which relies on the Securities Act's section 4(1) exemption from registration of securities sold "by a person other than an issuer, underwriter, or dealer." The term "underwriter," defined in Securities Act section 2(a)(11), means someone who purchased the securities with the intention to distribute them to others, like a traditional investment bank underwriter. A person who is not an underwriter can therefore resell Restricted Securities without registering them under section 4(1), and Rule 144 provides a "safe harbor" for doing so, just as Reg. D, Rule 506 provides a safe harbor for the

initial issuance of securities not involving a public offering pursuant to Securities Act section 4(a)(2).

Pursuant to Rule 144(d), if the Issuer has been a reporting company under Exchange Act section 13 or 15(d) for at least 90 days prior to the sale, at least six months must pass between the acquisition of the securities from the Issuer or any affiliate, and a resale of the securities in reliance on Rule 144. If the Issuer is not a reporting company pursuant to Exchange Act section 13 or 15(d) (or has not been for at least 90 days prior to the sale), then at least one year must pass between the acquisition of the securities from the Issuer or any affiliate and any resale in reliance on Rule 144. In either case, the holding period does not begin until the full purchase price or other consideration is paid by the acquirer of the securities to the Issuer or its affiliate. Rule 144 has additional rules for determination of when full payment is made and when the holding period begins in more complex situations. In the case of securities acquired from the Issuer in a transaction effected solely for the purpose of forming a holding company, the securities are deemed to have been acquired when the newly-formed holding company exchanged its shares for those of the predecessor Issuer.

Rule 144(h) requires, for reliance on the Rule 144 safe harbor for resales in excess of 5,000 shares or other units or in excess of $50,000 during any three month period, giving notice of the resale by filing SEC Form 144. Resellers must follow the "manner of sale" procedures set forth in Rule 144(f). Pursuant to Rule 144(e), no more than one percent (1.0%) of the outstanding shares or units of the issuer applicable may be sold by an Issuer affiliate in a three month period in reliance on Rule 144. Rule 144 has many requirements for particular situations involving resellers, purchasers and Issuers, which should be reviewed carefully to assure the safe harbor's benefit. In most cases, a stock purchase agreement and other ancillary documents containing negotiated representations, warranties, conditions, indemnities and other terms and conditions for the protection of reseller and purchaser should be prepared for the resale.

On December 22, 2020, the SEC proposed Rule 144 amendments to confirm that the holding period for so-called "market-adjustable securities," securities with a discounted conversion or exchange right based on market shifts, are subject to the above-stated six month (reporting company) and one year (non-reporting company) holding periods *from the date of conversion* to prevent resale of the underlying securities by converting them and then taking advantage of the built in discount in reselling, a kind of self-arbitrage. Form 144 will become electronic filing only.

b. Rule 144A: Rule 144A provides a separate safe harbor exemption for resale of Restricted Securities to institutions classified as "Qualified Institutional Buyers," or "QIBs," as defined in Rule 144A. QIBs are deemed, much like "Accredited Investors" in the case of original issuance of securities (see "Raising Capital"), sufficiently sophisticated so as not to need the protections provided by the disclosures required in the public registration process upon their purchase by resale of those securities. QIBs include insurance companies, investment companies and small business investment companies, investment advisers, employee benefit plans, trust funds, securities dealers registered under Exchange Act section 15 and banks. QIBs generally must own and invest on a discretionary basis an aggregate at least $100 million in the securities of issuers unaffiliated with them (or, in the case of registered securities dealers, at least $10 million, or be acting in a "riskless principal transaction" on behalf of a QIB). For banks, there is an additional $25 million audited net worth requirement for QIB status. Obviously, QIB qualification is a far higher threshold than Accredited Investor qualification, but provides a safe harbor for resale of Restricted Securities to QIBs when the Rule 144 holding period cannot be waited for to expire. Rule 144A(d) sets out conditions to be met for reliance on the Rule 144A exemption, notably reseller due diligence on the purchaser's QIB status.

   On August 26, 2020, the SEC adopted amendments to Rule 144A adding LLCs and RBICs to the types of entities eligible for QIB status if they meet the $100 million securities ownership and investment thresholds, and establishing a QIB "catch-all" category that would permit institutional Accredited Investors, as defined in Rule 501(a), to the extent not already qualified under Rule 144A to qualify as QIBs when they satisfy the $100 million threshold.

c. Rule 145: Rule 145 provides another safe harbor for the resale of Restricted Securities acquired in the course of business combinations such as mergers and acquisitions, stock swaps, securities reclassifications and related transactions involving the exchange of one security for another, as when shareholders of a company being acquired in a merger or acquisition transaction receive shares in the acquiring company in exchange for their own. Stock splits, reverse stock splits and changes in par value are not included in Rule 145's protections.

d. FAST ACT: Finally, the 2015 FAST Act enacted an amendment to the Securities Act section 4(a)(7), which provides an exemption for private resales of Restricted Securities. Section 4(a)(7) provides a safe harbor for the so-called Securities Act section 4(a)(1½) exemption, private resales by persons other than the issuer. It is generally used for resales to Accredited Investors who are not QIBs. Because section 4(a)(7) requires issuer information and therefore

cooperation, and because the resale purchaser receives Restricted Securities (unlike purchasers who purchase Restricted Securities after the Rule 144 holding period expires), the utility of section 4(a)(7) has been limited.

II. Deal Points

Deal Point No. 1: Resales of Restricted Securities are SEC regulated stock purchase and sale transactions. Resales of restricted securities are SEC-regulated stock purchase and sale transactions which require compliance, including due diligence and SEC filings in most cases and documentation in the form of a stock purchase agreement and ancillary documents demonstrating compliance with the resale exemption (holding period expiration, QIB status of purchaser or otherwise), containing terms and conditions usual for similar transactions, such as representations and warranties, conditions, indemnification and limitation of liability and termination provisions, among others, negotiated between the resale seller and purchaser.

Deal Point No. 2: Do due diligence on the resale purchaser, use the safe harbors and document the transaction. As with original issuance (see "Raising Capital," Deal Points section), selling unregistered securities to non-accredited investors or other purchasers lacking the requisite sophistication to be subject to lower disclosure regulations is rarely worth it, even when technically allowed under the Securities Act and SEC rules and regulations. If the securities have not been registered for resale under the Exchange Act, they are still Restricted Securities being resold under an exemption, and the issuer has not been subject to the Securities Act section 5 public registration disclosure regime, which is far more strict and extensive than for securities issued under registration exemptions and designed to protect retail investors. Non-sophisticated investors are more jealously protected by the SEC and are more likely to be treated with deference by it and by the courts. Accredited Investors and QIBs are the subject of safe harbors for a reason; they are less likely to succeed in spurious claims alleging misrepresentations or omission to state material facts if their purchase of the resale securities does not produce the return on investment they hoped for and seek to recoup their money from the investor. That consideration is of course also the reason to document the reseller's representations, warranties, covenants and other terms and conditions in a stock purchase agreement; the stock purchase agreement in this case performs the same "insurance policy" function to avoid nuisance law suits by disgruntled investors that the private placement memorandum or offering circular performs in issuer private placements (see "Raising Capital," Deal Points). Safe harbors like Rule 144, Rule 144A and Rule 145 are there for reseller protection against civil suits by disgruntled counterparties and SEC enforcement, which comes in both civil and criminal forms. Compliance with regulatory safe harbors does not cost much, especially in proportion to all but the smallest resales.

Deal Point No. 3: Don't commit fraud! The anti-fraud prohibitions of the Securities Act, Exchange Act and associated rules and regulations apply to any offer and sale or resale of securities, whether to Accredited Investors or QIBs or non-accredited investors, and whether exempt from registration or not. Fraud can occur by the misrepresentation of material facts that a purchaser relies upon to its detriment in its decision to purchase the securities, *or by the omission to state material facts.* For this reason, even in resales to the most sophisticated or institutional investors, it is sound practice to provide some form of documentation in the stock purchase agreement to memorialize what was represented about the securities being resold and what was not. Inadvertent technical errors in the securities offering and resale process can often be fixed or excused. Fraud cannot. Don't commit fraud.

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