

SELLING RESTRICTED SECURITIES

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I. Introduction

- A. Registration or exemption required for all sales or issuances of securities
- B. Other issues affecting sales of securities, whether or not restricted
 - 1. Insider trading restrictions
 - (a) Securities law restrictions
 - (b) Issuer insider trading policies
 - 2. Contractual restrictions
 - (a) Lock-up agreements
 - (b) Shareholder agreements
 - 3. Section 16 of the Exchange Act
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 - (b) Requires filings of Forms 3, 4, and 5
 - 4. Section 13 of the Exchange Act
 - (a) Requires filing of Schedule 13D or 13G

II. Definitions

A. “Affiliate”: An affiliate of an issuer is a person that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, such issuer. Affiliates can be individuals or entities. Typically, affiliates include:

- 1. Executive Officers at the highest levels
- 2. Directors
- 3. Controlling stockholders - facts and circumstance test
- 4. Subsidiaries, parents and sister companies

B. “Restricted Securities”: Securities acquired in unregistered issuances from an issuer or unregistered private transfers from an affiliate of such issuer. Some typical ways to acquire restricted securities are:

1. Private Placement from issuer, including:
 - (a) Section 4(2) - an exemption for transactions by an issuer not involving a public offering. Some examples include:
 - (i) Founder’s stock
 - (ii) Nonpublic offerings to a limited number of investors
 - (iii) Compensation for services
 - (b) Regulation D - an exemption for certain non-public offerings
 - (c) Regulation S - an exemption for certain offshore offerings
2. Rule 144A - provides a basis for certain private resales of unlisted restricted securities by any person other than an issuer to qualified institutional buyers (“QIBs”). QIBs include:
 - (a) certain entities that own and invest at least \$100 million in securities.
 - (b) a dealer that owns and invests at least \$10 million in securities.
 - (c) a dealer acting in a riskless principal transaction on behalf of a QIB.
 - (d) an entity, all of the equity owners of which are QIBs.
 - (e) certain banks.
3. Rule 701 - an exemption for the issuance by non-reporting companies of securities under employee benefit plans.
4. Rule 145 - registered securities acquired in certain business combinations and other transactions are treated as restricted securities.
5. 4 (1-1/2) - an exemption that is construed to provide for the private sale of securities by affiliates to sophisticated investors.
6. Private purchase of restricted securities from non-affiliates.

C. “Unrestricted Securities”

1. Open market purchase
2. Private purchase of unrestricted securities from non-affiliate
3. Registered securities, including Form S-8 registration of securities issued under employee benefit plans

D. “Control Securities”: Any securities held by an affiliate of an issuer, regardless of how acquired.

III. Selling Securities

A. Methods of Sale

1. Rule 144
 - (a) Current Public Information

- (i) Issuer has securities registered under the Securities Exchange Act of 1934 or the Securities Act of 1933.
 - (ii) Issuer has been subject to reporting requirements for at least 90 days immediately preceding the sale of securities.
 - (iii) Issuer has filed all required reports during the 12 months preceding the sale (or such shorter period that the issuer was required to file reports).
 - (iv) Seller is entitled to rely on statement in most recent SEC report of issuer required to be filed and filed that such issuer has filed all required reports and has been subject to the filing requirements for 90 days, unless seller knows or has reason to believe that the issuer has not complied with such requirements.
- (b) Holding Period for Restricted Securities
- (i) Resale of restricted securities owned by an affiliate or being sold on behalf of an affiliate requires a holding period of:
 - For reporting companies, six months before the securities may be sold publicly (seller must comply with current public information, volume limitations, manner of sale, and filing of form 144 requirements);
 - For non-reporting companies, twelve months before the securities may be sold publicly (seller must comply with the current public information, volume limitations, manner of sale, and filing of form 144 requirements).
 - (ii) Resale of restricted securities by a non-affiliate who has not been an affiliate during the prior three months requires a holding period of:
 - For reporting companies, six months before the securities may be sold publicly (seller must comply with current public information requirements);
 - For non-reporting companies, one year for the securities to be sold publicly without any Rule 144 requirements.
 - (iii) Computing holding periods
 - The six-month and twelve-month periods begin after full purchase price paid by person that acquires securities from the issuer or an affiliate of the issuer.
 - A promissory note or other obligation to pay the purchase price counts as full payment only if it (1) provides for full recourse against the purchaser of the securities, (2) is secured by sufficient collateral other than the securities being purchased, and (3) is discharged in full prior to the sale of the securities.
 - Upon exercise of a warrant by means of a “cashless exercise”, the holding period for the underlying securities is deemed to include the time the warrant was held.

- (iv) Tacking provisions - there are special holding period rules that permit tacking, in the following circumstances:
- Stock dividends, splits and recapitalizations - securities deemed to have been acquired when original securities acquired
 - Conversions - securities acquired deemed to have been held for time of securities surrendered for conversion
 - Contingent issuance of securities - contingent issuances of securities in connection with sale of business deemed to have been acquired when business sold
 - Pledged securities - if pledged with recourse, securities deemed to have been acquired at time of acquisition by pledgor. If the securities are pledged without recourse they shall be deemed to have been acquired by the pledgee at the time of the pledge.
 - Gifts of securities by affiliates- securities deemed to have been acquired when donor acquired them
 - Trusts - securities deemed to have been acquired when settlor acquired them
 - Estates - securities deemed to have been acquired when deceased acquired them. There is no holding period for an estate that is not an affiliate of the issuer.
 - Holding Company Conversions: may be tacked where (i) the holding company stock was issued solely in exchange for stock of the predecessor company; (ii) the security holder received securities in the same proportion, right and interest as the securities exchanged; (iii) the holding company was newly formed and had no significant assets except for the predecessor company securities immediately after the transaction.
 - Rule 145(a) transactions - holding period commences on date securities acquired by purchaser in Rule 145 transaction
- (c) Limitation on Amount of Securities Sold
- (i) Amount of securities sold in any three-month period shall not exceed the greater of:
- one percent of the shares outstanding for equity securities or for debt securities, ten percent of a tranche (or class, in the case of non-participatory preferred stock) ; or

- (iii) such person is not an affiliate of the issuer and has not been an affiliate for at least three months and has held the securities for at least two years, regardless of the issuer meeting Rule 144 current public information requirements.
- 3. Registration for Resale - Securities that are registered for resale by the holder may be sold pursuant to the prospectus contained within the registration statement relating to such securities without regard to the limitations of Rule 144.
 - (a) Plan of distribution compliance
 - (b) Prospectus delivery requirements
 - (c) Seller must be named in prospectus as selling security holder
 - (d) Seller still permitted to sell in accordance with Rule 144
- 4. Section 4(1)
 - (a) Provides for a sale of securities by a person other than an issuer, underwriter or dealer.
 - (b) Not available to affiliates
- 5. 4(1-½) - See Section II.B.5 above.
- 6. Rule 144A- See Section II.B.2 above.

B. Contractual Restrictions

- 1. Lock-up agreements
- 2. Tag-along, Drag-along, Right of first refusal

C. Insider Trading Restrictions

- 1. Rule 10b-5
 - (a) unlawful, in connection with the purchase and sale of any security, to:
 - (i) employ any device or scheme to defraud;
 - (ii) make any material untrue statement or omission; or
 - (iii) engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.
 - (b) Persons with inside information must abstain from trading or disclose the information
 - (c) Materiality test - would a reasonable investor consider such untrue or omitted statement important in decision to buy/sell stock
- 2. Rule 10b5-1
 - (a) adopted stricter “possession” standard for insider trading liability under Rule 10b-5, rather than the “actual use” standard that many courts used.
 - (b) provides an affirmative defense from Rule 10b-5 liability for anyone who purchases or sells securities at a time when he or she possesses material non-public information, provided:

- (i) before becoming aware of the material non-public information, the person had, in good faith
 - entered into a binding contract to trade;
 - instructed another person to trade; or
 - adopted a written plan; and
 - (ii) the contract, instruction or plan either;
 - specifies (or provides a written formula or mechanism for determining) the amount, price and date of the transaction(s); or
 - does not permit the insider to exercise any subsequent influence over how, when or whether to effect sales or purchases (and any person who does exercise such influence is not aware of material non-public information when doing so).
 - (c) As a result of Rule 10b5-1, many insiders enter into “Rule 10b5-1 plans”, which are written arrangements that comply with the above referenced rules.
 - (d) As a practical matter, 10b5-1 plans can be terminated while insider is in possession of inside information, but abuse of this can be deemed to be lacking in “good faith”.
3. Insider Trading restrictions apply to:
- (a) corporate "insiders" (e.g., officers, directors, employees, controlling shareholders).
 - (b) Other persons with duty of trust or confidence. Rule 10b5-2 defines such persons to include:
 - (i) a person who agrees to maintain information in confidence;
 - (ii) where the parties have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the information expects that the recipient will maintain its confidentiality; or
 - (iii) in most cases where a person (the trader) receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling.
4. Insider Trading Policies of Issuer:
- (a) blackout periods (current trend) - when you can't sell
 - (i) Generally from the date the earnings of the issuer become apparent until two days after the filing of a report for the period with the SEC (when the market is assumed to have digested the information)
 - (b) window periods - when you can sell
 - (i) Generally beginning two days after the filing of a report with the SEC and ending two to three weeks later
 - (c) pre-clearance policies - must clear sales with issuer prior to selling
 - (d) pre-approval of 10b5-1 plans

D. Short Swing Profit Liability Under Section 16(b) of the Exchange Act.

1. Any profit realized by an insider from any purchase and sale, or any sale and purchase, of any equity security (other than certain exempted securities) of the issuer which were effected within a period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall be recoverable by the issuer.
2. Liability is strictly imposed through a purely objective test, regardless of whether an insider did in fact possess or misuse material inside information and/or profit from it.
3. To calculate the profit realized in a Section 16 action, the highest sales price in the six-month period is matched against the lowest purchase price in such period. The fact that no true monetary gain may have been realized by the insider does not matter.
4. Exemptions from Section 16(b) -- Certain sale and purchase or purchase and sale transactions effected within six months are exempt or excluded from Section 16(b):
 - (a) the exercise or conversion of an in-the-money derivative security is generally exempt pursuant to Rule 16b-6. Thus, a statutory insider may typically exercise an in-the-money employee stock option and immediately sell the underlying common stock, provided the statutory insider has not otherwise purchased shares within six months prior to such sale and does not purchase shares within six months thereafter.
 - (b) any transaction by a 10% shareholder during the period before or after such person has such status is exempt.
 - (c) transactions between an issuer and its officers and directors can be exempt primarily pursuant to Rule 16b-3. If such transactions are pursuant to certain tax qualified employee benefit plans (e.g. 401(k), stock purchase plans and profit-sharing plans), they are generally unconditionally exempt. Transactions can also be exempt under 16b-3 if:
 - the board of directors or a committee of two or more non-employee directors approve them in advance,
 - the stockholders approve them in advance or ratifies them prior to the next annual meeting of stockholders or
 - the insider holds the acquired securities for at least six months.
5. Insiders need to file Forms 3, 4 and 5.

E. Section 13 of the Exchange Act

1. Any person or group of persons acquiring beneficial ownership of 5% or more of a class of securities registered under Section 12 of the Exchange Act must file a Schedule 13D with the SEC within 10 days after such acquisition
2. Amendments to a Schedule 13D must be filed if there is any material change in the information included in the Schedule 13D. A change beneficial ownership of 1% or more is deemed material, although lesser changes may also be material.
3. Passive investors may file a short form Schedule 13G in lieu of Schedule 13D. A 13G must be amended within 45 days after the end of the calendar year if there are any changes in the information previously reported. Amendments to Schedule 13G must be filed in shorter time frames upon acquisition of 10% or more of a class of equity securities and upon any change in ownership of 5% or more.