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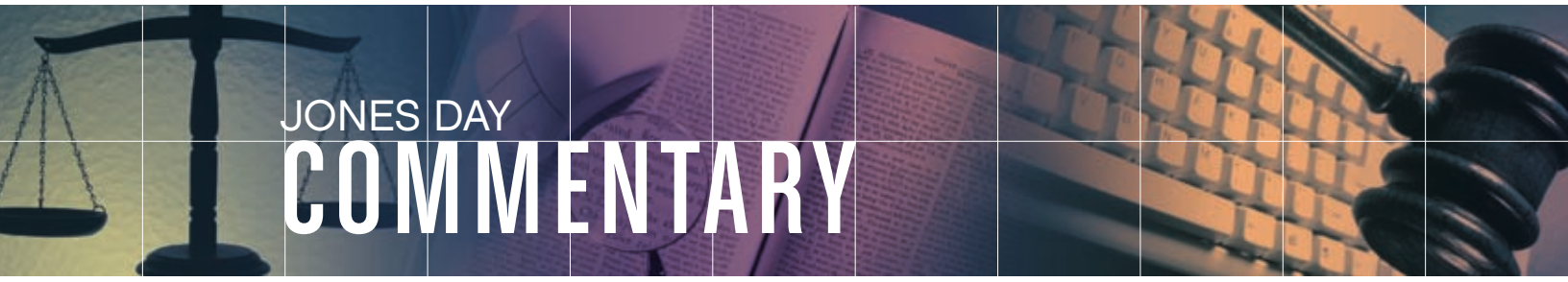

SEC PROPOSES PRIVATE OFFERING REFORMS AND OTHER RELIEF FOR SMALLER COMPANIES

Over the past several months, the Securities and Exchange Commission has proposed new rules that would modernize existing regulations governing private placements of securities for all companies, including PIPEs (private investments in public equity), and registration and reporting requirements for smaller reporting companies. The proposals would, among other things, do the following:

- increase the availability of the safe harbor afforded by Regulation D;
- make Rule 144 available sooner to allow holders of restricted securities of reporting companies to resell them in the market with no or fewer restrictions, depending on the circumstances;
- eliminate and revise the restriction of Rule 145 regarding exchanges of securities in business combination transactions;
- provide an exemption from the registration requirements of the Securities Act for grants of compensatory stock options by private companies; and
- make the Form S-3 registration statement, which is abbreviated and more flexible to allow quicker access to the capital markets compared to the Form S-1 registration statement, more widely available to public companies.

Some of the proposals were discussed in an open meeting of the SEC that was followed by a press release dated May 23, 2007.[1] On June 20 and 22, 2007, the SEC issued releases containing proposed changes to the eligibility requirements for the use of registration statements on Form S-3[2] and to Rule 144 and Rule 145 under the Securities Act.[3] Future releases containing additional changes discussed in the May 23, 2007, press release are expected. All of these proposals are subject to review and comment and final rulemaking action by the SEC.

This *Commentary* provides a brief background about and summarizes these proposals.

BACKGROUND

We believe that the proposed new rules are largely a response by the SEC to the following:

Private Offering Reforms Generally. The proposals generally reflect several reforms that have been discussed for the past several years among the SEC, investors, and practitioners. Several of these proposals were contained in prior proposed rule changes by the SEC and were the subject of a 2007 American Bar Association letter to the SEC.[4] Although not as far-ranging as the SEC's 2006 securities offering reforms relating to public offerings, the new proposals are an attempt to modernize the private offering process in several important respects.

Rule 415 Controversy. Recently, there has been a lack of clarity about the SEC's position regarding the availability of shelf registration statements for companies that seek to register the resale of a large amount of equity or equity-linked securities that were initially sold in a private placement. In many private placements, such as PIPEs, the issuer will usually enter into a registration rights agreement with its investors that requires the issuer to file and have declared effective by the SEC a resale shelf registration statement and, using that registration statement, to provide the investors with the ability to freely resell the securities initially purchased in the private offering on a delayed basis under Rule 415 of the Securities Act. In the recent past, the SEC has taken the position that such a registration statement may not be declared effective unless, based on all the facts and circumstances, the issuer would be eligible to use a Form S-3[5] for a primary offering (that is, securities offered by a company for its own account). The SEC's position appears to be that such a purported secondary offering (secondary because it is being done to allow security holders to sell their securities) really constitutes a disguised primary offering. Because resale registration statements in this situation contemplate investors selling securities over time at potentially different prices, the SEC has taken the position that such an offering is a continuous one and, as such, is only permissible pursuant to Rule 415. Rule 415 is only available to issuers that are eligible to use Form S-3 for a primary offering.

The SEC's Rule 415 position has caused several unexpected disruptions in the market.

- Many issuers have incurred substantial liquidated damages for having failed to have the resale registration statement declared effective on a timely basis as required by their registration rights agreements because they are ineligible to use a Form S-3 since their float is less than the $75 million required by Form S-3 for such transactions.
- The lack of clarity about this position has caused many companies to either restructure or avoid private placements because of the regulatory uncertainty.
- As a result of the above, many of the investors in these transactions have had to continue to own restricted securities longer than expected because of the unavailability of the shelf registration statement and have had to wait one year to avail themselves of Rule 144 to resell such securities without restriction.

Given the size and significance of the private placement and PIPEs market[6] and the controversy that has ensued regarding this issue, we believe that several of the proposals are aimed, in part, at easing the regulations relating to Form S-3 eligibility and widening the availability of Rule 144.

Easing the Registration and Disclosure Burden on Smaller Companies. Smaller companies, practitioners and the media have been commenting on, and the SEC has been investigating, the burdens the federal securities laws and the Sarbanes-Oxley Act of 2002 place on smaller businesses.[7] The 2006 final report of the SEC's Advisory Committee on Smaller Public Companies contains several recommendations that are contained in the new proposals.

PRIVATE OFFERING REFORMS

The proposed new rules would expand the ability to effect private placements under Regulation D of the Securities Act and would liberalize the use of Rule 144 for resales of restricted securities.

Regulation D. Regulation D provides a safe harbor from the registration requirements of the Securities Act by allowing the offer and sale of securities on a private placement basis. To qualify for a Regulation D offering, the issuer must satisfy several conditions: Offers must be limited to defined categories of sophisticated investors; the issuer must not have completed or be completing another private placement

that would be integrated with the offering in question either six months before or after the offering; and the issuer must not be engaged in any form of general solicitation or general advertising. Regulation D provides the legal basis under the federal securities laws, in addition to Section 4(2) of the Securities Act, upon which most PIPEs and traditional private placements are structured.

The Proposals. The most significant impact of the proposals would be to expand the availability of the Regulation D safe harbor to more investors, permit limited advertising, and reduce the length of the integration safe harbor.

- *Increasing the Availability of the Safe Harbor*. The proposals would expand the definition of an "accredited investor" by adding an investments-owned standard to the current total assets and net worth elements of the definition. The addition of the investments-owned standard would increase the number of investors that could participate in an offering pursuant to the Regulation D safe harbor. The SEC staff has indicated that, in order to meet the investments-owned standard, an individual would need to own $750,000 and an institution would need to own $5 million of investments. The proposals would also provide for adjustments to the definition of "accredited investor" in Regulation D to account for inflation. The first adjustment for inflation would occur in five years.
- *Permitting Limited Advertising*. Currently, the offer and sale of securities made pursuant to the Regulation D safe harbor may not involve any sort of general solicitation or advertising. The proposals would establish an exemption in new Rule 507 of Regulation D for sales of securities to a new category of qualified purchasers with respect to which the issuer could engage in limited advertising, such as tombstone advertisements, without being considered a general solicitation or advertisement.
- *Reducing the Integration Safe Harbor.* Currently, Regulation D states that offerings that occur more than six months apart will not be integrated. The proposals would shorten that period to 90 days.

In addition, the proposals would also:

- apply the disqualification provisions by which "bad actors" are not permitted to participate in Regulation D offerings, which is currently limited to offerings under $5 million, to all offerings under Regulation D; and
- update, simplify, and require the electronic filing of information required by Form D, which is the form required to be filed with the SEC in connection with completed Regulation D offerings.

Rule 144. Rule 144 provides a safe harbor from the registration requirements of the Securities Act for limited public resales of restricted securities and allows the person reselling these securities to avoid being deemed an underwriter for Securities Act purposes. Rule 144 is used primarily for resales of securities acquired in a private placement from the issuer, an affiliate of the issuer, or through a chain of transactions through which the securities were originally sold by the issuer or the affiliate, as a result of which the securities would normally be restricted and not freely transferable. To qualify for a Rule 144 resale, several conditions must be satisfied: There must be adequate current information about the issuer on file with the SEC; the seller must have held the securities for a specified period of time (depending on its status as an affiliate or a nonaffiliate of the issuer) to ensure that that person has assumed the economic risk of investment for some time; and the seller must, depending on the circumstances, comply with the additional limitations of volume, manner of sale, and Form 144 filing requirements. Currently, resales of restricted securities by nonaffiliates may be made subject to the additional limitations after a one-year holding period and on an unlimited basis after a two-year holding period, and resales of restricted securities by affiliates may be made subject to the additional limitations after a one-year holding period.

The Proposals. The proposals would:

- shorten the holding period for both affiliates and nonaffiliates for restricted securities of reporting companies to six months, subject to complying with the other conditions of Rule 144 when applicable—with the following additional provisions:
  - resales by nonaffiliates would be subject only to the current public information requirement between the end of the six-month holding period and one year after the acquisition date of the securities;
  - resales by nonaffiliates after a one-year holding period would not be subject to any other limitations or requirements;

    - to qualify for nonaffiliate status, the person cannot have been an affiliate during the three months prior to the resale; and
    - resales by affiliates after the six-month period would be subject to the additional limitations.
- keep the holding period for restricted securities of nonreporting companies at one year for both affiliates and nonaffiliates, although nonaffiliates would be subject to no other condition after meeting the one-year holding period;
- include a provision that would toll the six-month holding period referred to above while the security holder is engaged in certain hedging transactions (such as short positions or put equivalent positions), although under no circumstance would the holding period extend beyond one year;
- change the manner of sale limitations for both affiliates and nonaffiliates, including that securities be sold in brokers' transactions, so that they do not apply to resales of debt securities, nonparticipating preferred stock, and asset-backed securities;
- change the filing requirements for Form 144 by raising the thresholds that trigger the filing requirement to trades of 1,000 shares or $50,000 within a three-month period for affiliates and adding some additional information to be included in the form, such as that regarding short positions prior to the resale of the securities; and
- simplify other parts of Rule 144 and codify certain SEC staff interpretations relating to Rule 144.

The proposals would codify, among others, the following SEC staff interpretations about Rule 144:

- securities acquired under Section 4(6) of the Securities Act, which provides an exemption from registration for offerings below $5 million that are made to accredited investors and satisfy other conditions, are considered restricted securities for purposes of Rule 144;
- the tacking of holding periods is permitted when a company reorganizes into a holding company structure—meaning that holders may add the time that the securities are held before a transaction that forms a holding company as part of the time they hold the securities used to meet the applicable Rule 144 holding period, if specified conditions are met;
- the tacking of holding periods is permitted for conversions and exchanges of securities—meaning that, if the securities sold were acquired from the issuer solely upon conversion or in exchange for other securities of the same issuer, the newly acquired securities will be deemed to have been acquired at the same time as the securities surrendered for conversion or exchange, even if the securities surrendered were not convertible or exchangeable by their terms;
- upon a cashless exercise of options or warrants, the newly acquired underlying securities are deemed to have been acquired when the corresponding options or warrants were acquired even if the options or warrants originally did not provide for cashless exercise by their terms; and
- securities issued by "reporting and nonreporting shell companies" are not eligible for resale under Rule 144 subject to specified modifications.

The aspects of the Rule 144 proposals that would appear to have the most significant impact are those that would reduce by half the existing holding periods for securities of reporting companies and that would eliminate the volume, manner of sale, and filing requirements for nonaffiliate resales. These proposals, among others, are aimed at increasing the liquidity of privately placed securities. As such, these proposals may be, in part, a response by the SEC to one of the effects of its Rule 415 position, which have left some investors holding restricted securities longer than they expected. In addition, the SEC did observe without elaboration that, by reducing the holding period for restricted securities, the proposed amendments would enable companies to raise capital more often through the issuance of securities in unregistered transactions, such as offshore offerings under Regulation S or other transactions not involving a public offering, rather than through financing structures including extremely dilutive convertible securities.

The SEC explained one of its motivations regarding the inclusion of the proposed tolling provision relating to hedging transactions as follows: "[W]e are concerned about the effect of hedging activities designed to shift the economic risk of investment away from the security holder with respect to restricted securities to be resold under Rule 144. It becomes more difficult to conclude that the security holder who

engages in hedging transactions, and thereby transfers the economic risk of the investment to a third party, soon after acquiring the security, has held the security for investment purposes and not with a view to distribution. . . . The proposed six-month holding period requirement could make the entry into such hedging arrangements significantly easier and less costly because they would cover a much shorter period."

In addition, the SEC is soliciting comment on whether to permit a delay in the deadline for filing a Form 144 to coincide with the deadline for filing a Form 4 under Section 16 of the Exchange Act. The SEC is also soliciting comment on whether to permit affiliates of issuers that are subject to the filing requirements of Section 16 of the Exchange Act to satisfy their Form 144 filing requirements by timely filing a Form 4.

Rule 145. Rule 145 of the Securities Act provides that exchanges of securities in connection with reclassifications of securities, mergers, consolidations, or transfers of assets that are subject to shareholder vote constitute sales of those securities. The thrust of the rule is that an offer to sell securities is generally made to security holders under an agreement, such as a merger agreement, pursuant to which the holders are required to elect, on the basis of what is in substance a new investment decision, whether to accept a new or different security in exchange for their existing security. As a result, such exchanges must be registered under the Securities Act. Rule 145 deems persons who were parties to such transactions, other than the issuer or affiliates of such parties, to be underwriters under the SEC's presumptive underwriter doctrine and sets forth the restrictions on the resale of securities received in such transactions by persons deemed to be underwriters.

The Proposals. The proposals would:

- eliminate the presumptive underwriter doctrine except with regard to transactions involving blank-check or shell companies; and
- revise resale provisions of the rule for persons and parties deemed presumed underwriters to permit them to resell their securities to the same extent that affiliates of a shell company would be permitted to resell their securities, under Rule 144, as proposed.

Registration Exemptions for Compensatory Stock Options. The grant of employee stock options by a company may be subject to registration if the company has 500 or more holders of record of options and has assets in excess of $10 million. As a result of such grants, public companies may be required to register the grant, and private companies that would not otherwise be subject to the registration and ongoing disclosure requirements of the Exchange Act may become subject to these requirements.

The Proposals. The proposals would:

- provide an exemption for private nonreporting issuers from registration for compensatory employee stock options issued under employee stock option plans; and
- provide an exemption from registration for compensatory employee stock options issued by issuers that have registered under Section 12 of the Exchange Act the class of securities underlying the compensatory stock options.

The effect of these proposals would be to liberalize the use of compensatory stock options by private companies without the concern of having to satisfy registration and ongoing disclosure obligations.

SMALLER COMPANY REGISTRATION AND DISCLOSURE

Registration. Companies that are eligible to use registration statements on Form S-3 have several advantages over those that are limited to Form S-1. Some background on these forms:

- *Form S-3*. To be eligible to use Form S-3, the company must have a class of securities registered under the Exchange Act, have made all timely filings required of it under the Exchange Act for the 12 months preceding the filing of the registration statement, and, depending on the nature of the proposed offering, have a public float[8] of greater than $75 million. The main advantages of using this form is that it is a shorter form that permits incorporation by reference from existing and future SEC filings and, as a result, does not require updating for future SEC filings made after the registration statement is declared effective. In addition, it permits eligible companies to access

the capital markets more quickly because of the nature of the "shelf" takedown process under Rule 415. Rule 415 provides considerable flexibility in accessing the public securities markets from time to time in response to changes in the market and other factors. Companies that are eligible to register these primary shelf offerings under Rule 415 are permitted to register securities offerings prior to planning any specific offering and, once the registration statement is effective, offer securities in one or more tranches without waiting for further SEC action.

- *Form S-1*. Companies that are not eligible to use a Form S-3 usually are required to use a Form S-1. Registration of an offering on Form S-1 permits the issuer to incorporate by reference previously filed Exchange Act reports, but it does not permit registrants to automatically update information in the prospectus by forward incorporation of these reports filed after the registration statement is declared effective. Further, Form S-1 issuers are not permitted to register primary shelf offerings under Rule 415. Thus, it is difficult for Form S-1 issuers to take advantage quickly of favorable market opportunities.

The Proposals. As a general matter, the proposals would amend the eligibility requirements of Form S-3 to allow issuers to conduct primary offerings on this form, whether or not they satisfy the $75 million minimum float threshold, so long as they satisfy the other eligibility conditions of the respective forms and do not sell more than the equivalent of 20 percent of their public float in primary offerings over any period of 12 calendar months. Specifically, the SEC is proposing to allow companies with less than $75 million in public float to register primary offerings of their securities on Form S-3, provided they:

- meet the other registrant eligibility conditions for the use of Form S-3, meaning mainly that they have a class of securities registered under the Exchange Act and have been timely in their Exchange Act filings;
- are not shell companies and have not been shell companies for at least 12 calendar months before filing the registration statement; and
- do not sell more than the equivalent of 20 percent of their public float in primary offerings over any period of 12 months.

It is important to note a few observations about the 20 percent limitation:

- The SEC release contains a detailed set of guidelines upon which to make the calculation.
- The calculation may include both equity and debt securities. As a result, the SEC would allow companies relying on the new Form S-3 eligibility requirements to be able to offer noninvestment grade debt on Form S-3.
- The proposed 20 percent limitation is not intended to affect a holder's ability to convert or exercise derivative securities purchased from the company. For example, the 20 percent limit would apply to the amount of common stock warrants that a company could sell under Form S-3, and the number of common shares into which the warrants are exercisable would be relevant for determining the company's compliance with the 20 percent rule at the time the warrants were sold. But, the 20 percent limit would not impede the purchaser's later exercise of the warrants.
- Because the restriction on the amount of securities that can be sold over a period of 12 calendar months is calculated by reference to a company's public float immediately prior to a contemplated sale, as opposed to the time of the initial filing of the registration statement, the amount of securities that an issuer is permitted to sell can continue to grow over time as the issuer's public float increases. Conversely, the amount of securities that an issuer is permitted to sell at any given time may also decrease if the issuer's public float contracts.
- If, following the effective date of a registration statement, the company's public float exceeds $75 million, the 20 percent restriction would no longer be applicable to the company for as long as the company's public float exceeds $75 million.

The proposals are intended to allow smaller public companies that have been timely in filing their reports for at least one year to benefit from the greater flexibility and efficiency in accessing the public securities markets afforded by Form S-3. This proposal would affect a large number of already public companies—of the 9,428 registered companies, as of June 2005, 4,171, or 44.2 percent, had a market capitalization equal to or less than $75 million.[9] In addition, the SEC has also proposed that conforming changes be made

to Form F-3 for primary offerings by foreign private issuers. These proposals would expand the number of issuers that could have a registration statement declared effective relating to the resale of privately placed securities under Rule 415, among other things.

Additional Amendment. In addition, on April 18, 2007, the SEC amended Rule 146 under the Securities Act, which designated securities listed on the NASDAQ Capital Market tier of The NASDAQ Stock Market LLC (formerly the SmallCap Market) as "covered securities" for purposes of Section 18 of the Securities Act.[10] As a result, the securities listed on the NASDAQ Capital Market, as well as securities on par with, or senior to, such securities, are exempt from all state or "blue sky" regulation. Prior to this amendment, companies listed on the NASDAQ Capital Market that filed a registration statement with the SEC were required to make a similar filing with, or a request for an exemption from or qualification under the comparable registration requirement of, state securities laws. State securities law registration has proved a burdensome and expensive proposition for some issuers, with no certainty of passing the review of some state securities commissions. Not passing this review for some companies may have called into question their compliance with registration rights agreements that required such registration. As a result of this amendment, there is no longer a need for such efforts for NASDAQ Capital Markets listed companies.

Disclosure. Currently, Regulations S-B provides disclosure and reporting requirements for small business issuers. These requirements are less extensive and burdensome than those that apply to other issuers under Regulation S-K. The S-B disclosure regime is currently available only to issuers with a public float of less than $25 million.

The Proposals. The proposals would:

- expand eligibility for the scaled disclosure and reporting requirements for smaller companies by making the requirements available to all companies with up to $75 million in public float;
- simplify disclosure and reporting requirements for smaller companies eligible to use them—small business issuers and nonaccelerated filers—by combining for most purposes these categories into one category called "smaller reporting companies";
- simplify the disclosure and reporting requirements for smaller reporting companies by integrating current Regulation S-B disclosure requirements for smaller companies into the disclosure requirements of Regulation S-K for all other companies; and
- eliminate the "SB" forms for smaller companies.

These proposals would allow more companies to take advantage of the SEC's scaled, or reduced, disclosure requirements and would simplify the regulatory requirements for smaller reporting companies. This proposal would affect a large number of already public companies—of the 9,428 registered companies, 1,530, or 16.2 percent, had a market capitalization of between $25 and $75 million.[11]

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Thomas C. Daniels
1.216.586.7017
tcdaniels@jonesday.com

Alexander A. Gendzier
1.212.326.7821
agendzier@jonesday.com

Christopher M. Kelly
1.216.586.1238/
1.212.326.3438
ckelly@jonesday.com

Richard M. Kosnik
1.212.326.3437
rkosnik@jonesday.com

Timothy J. Melton
1.312.269.4154
tjmelton@jonesday.com

NOTES

1 Press Release, U.S. Securities and Exchange Commission, Modernization of Smaller Company Capital-Raising and Disclosure Requirements (May 23, 2007), *available at* http://www.sec.gov/news/press/2007/2007-102.htm ("Press Release").

2 *Id.*; Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3, Securities Act Release No. 33-8812 (June 20, 2007), *available at* http://www.sec.gov/rules/proposed.shtml.

3 Press Release; Revisions to Rule 144 and Rule 145 to Shorten Holding Period for Affiliates and Non-Affiliates, Securities Act Release No. 33-8813 (June 25, 2007), *available at* http://www.sec.gov/rules/proposed.shtml.

4 Letter from the American Bar Association to John W. White, Director, SEC – Div. Corp. Fin. (Mar. 22, 2007), *available at* http://www.abanet.org/buslaw/committees/CL410000pub/comments/20070322000000.pdf.

5 For convenience, references to Form S-3 also include F-3, as appropriate.

6 In 2006, there were 2,720 private placements totalling $88.4 billion and 1,343 PIPEs totalling $28.3 billion, and by June 22, 2007, there have been 1006 private placements totally $65.8 billion and 619 PIPEs totaling $21.4 billion, according to Sagient Research. Sagient Research, *available at* http://www.sagientresearch.com/pt/Stats.cfm?Type=9; Sagient Research, http://www.sagientresearch.com/pt/Stats.cfm?Type=17.

7 *See, e.g.*, Ivy Xiying Zhang, *Economic Consequences of the Sarbanes-Oxley Act of 2002* (2005); Lara Bergen, *The Sarbanes-Oxley Act of 2002 and its Effects on American Businesses* (2005); Christian Leuz, Alexander Triantis & Tracy Wang, *Why Do Firms Go Dark?: Causes and Economic Consequences of Voluntary SEC Deregistrations* (2006); and Securities and Exchange Commission Advisory Committee on Smaller Public Companies, Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (Apr. 23, 2006), *available at* http://www.sec.gov/info/smallbus/acspc.shtml.

8 "Public float" is the aggregate market value of the issuer's outstanding voting and nonvoting common equity held by nonaffiliates.

9 Securities and Exchange Commission Advisory Committee on Smaller Public Companies, Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission at E-3 (Apr. 23, 2006), *available at* http://www.sec.gov/info/smallbus/acspc.shtml.

10 Covered Securities Pursuant to Section 18 of the Securities Act of 1933, Securities Act Release No. 33-8791 (Apr. 18, 2007), *available at* www.sec.gov/rules/final/2007/33-8791.pdf.

11 *Id.*