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SEC Rules for Smaller Public Firms, Rule 144 Changes

During December 2007, the Securities and Exchange Commission (SEC) adopted a variety of new rules which affect smaller public companies. These rules provide for greater flexibility for capital raising and attempt to diminish the reliance of issuers on more onerous capital raising structures.

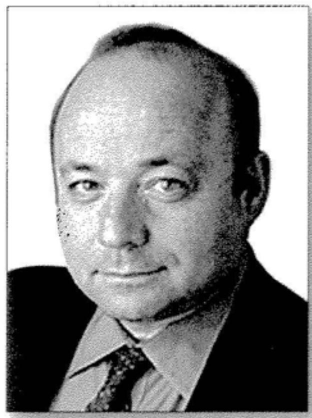
Another set of rules adopted in December 2007 eliminate the current Regulation S-B disclosure regime, move the relevant disclosure provisions into a now "two-tiered" Regulation S-K and broaden the category of issuers eligible to utilize scaled down disclosure requirements.

This article is not intended to give a detailed summary of the various rule amendments adopted by the SEC but rather focus on the principal changes brought about by the amendments and gauge their potential impact on smaller public companies.

Capital-Raising Initiatives

The principal capital-raising initiatives adopted were the reduction of the holding period under Rule 144 and the ability of exchange traded issuers to conduct primary offerings on Form S-3. Rule 144 is the principal mechanism governing the resale of privately placed or "restricted" securities and securities held by "control persons" of public companies. Form S-3 is a "short-form" registration for sale or resale of securities but its availability is limited for certain issuers, depending on the transaction sought to be registered.

The Rule 144 amendments will permit a reporting issuer (an issuer which files periodic reports under the Securities Exchange Act of 1934) to issue securities in a private placement and permit the recipient to resell such securities publicly after a six-month holding period. A similar change in Regulation S will allow securities placed offshore under the exemption provided by Regulation S to also be resold publicly in the United States after six months. The critical factor that changes the capital-raising landscape is the new provision allowing a holder of privately placed securities that is not an "affiliate" (generally referring to a director, officer or 10 percent stockholder) to resell the securities after the six-month holding period without regard to Rule 144's volume limitations or manner of sale requirements. After one year, the current public information requirements of Rule 144 (generally requiring the issuer be current in its 1934 Act reports for a 12-month period) are also inapplicable.[1] "Affiliates," as discussed below, would remain bound to the volume limits, current public information and manner of sale requirements.



Impact of New Rules on PIPES

These changes are very significant from the perspective of affording an issuer an easier means to raise capital. The prior Rule 144 regime led to the practice of significant capital raises being undertaken through so called "PIPES," essentially a private placement followed immediately by a registration statement to permit the public resale of the privately placed shares.

PIPES pose a significant number of challenges to issuers. Typically, in order to compensate the investor for the lack of immediate liquidity, shares or other convertible securities are issued at a steep discount to the current market price. In addition, issuers would frequently be contractually obligated to pay the investor significant penalties if the resale registration statement for the privately placed shares was not declared effective within a certain period (generally between 90 and 120 days from funding).

Finally, these types of financings are generally accompanied by significant issuances of warrants which further dilute the issuer's stockholder base. In addition, the SEC has recently (informally) limited the number of shares that could be registered in a resale registration statement to approximately 30 percent of the issuer's public float (generally defined as shares held by nonaffiliates), thus further impairing the ability of issuers to conduct significant PIPE transactions.

There were also a number of technical concerns that arose during review of these transactions that would sometimes surface legal issues relating to the manner in which the private placement was conducted.

The new 144 holding period addresses these issues directly by providing the investor with certainty that it will have liquidity within six months. The new rules took effect on Feb. 15, 2008, but because they are explicitly retroactive to securities issued prior to this date, financings taking place prior to Feb. 15, 2008 have been structured to take advantage of the new rules.

While the evidence is anecdotal at this point, it appears that the rule amendments are having their intended effect in that traditional funding sources for PIPES seem willing to accept the six-month holding period rather than insist on a resale registration statement. It is less than clear, however, whether the discounts to market

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or warrant kickers are being affected by the new rules.

Thus, the uncertainty of liquidity engendered by SEC review of a resale registration statement, as well as the issue of penalties associated with registration statement effectiveness, can largely be avoided. However, one area where the registration statement issue still looms is with respect to warrants, as the holding period will not commence on the shares underlying warrants until the warrant is exercised, except for those warrants that are exercised cashlessly, i.e., by giving up a portion of the warrant shares to effect the warrant's exercise.

It is important to point out that for substantial financings, the investment must be structured to avoid the designation of the investor or investors as "affiliates." Affiliates, typically viewed as directors, officers and owners of more than 10 percent of an issuer's outstanding stock, do not have the ability to take advantage of Rule 144's liberalized provisions other than the provision for reduction of the holding period to six months.

The remainder of the Rule 144 requirements, most significantly the volume limitations and manner of sale requirements, continue to apply to affiliates in the same manner as previously in effect. As a result, some investment funds may structure their investments with so called "conversion caps"[2] so that the securities they acquire, typically convertible debentures, would not be convertible if it would bring the investor over the 10 percent threshold.

In this manner, the investors intend to avoid "affiliate" status and thus the limitations of Rule 144's application to affiliates. Affiliate status may also attach based on other "control" features in investment agreements such as the right to appoint directors and negative covenants against certain significant actions being taken without the investors' approval.

Form S-3 Amendments

Further capital-raising assistance to the smaller public company is found in the amendments to Form S-3. For the first time, issuers which have a less than $75 million public float (the market value of shares held by nonaffiliates) are able to utilize Form S-3 for primary "off the shelf" offerings. However, only issuers with shares which are traded on a "national securities exchange," the principal ones being NYSE, NASDAQ and the American Stock Exchange, can take advantage of the new rules.

This shuts out thousands of issuers who report under the 1934 Act but are listed only on the Bulletin Board. Contrary to the original proposal circulated by the SEC, in the adoption of the final rules, the SEC withdrew the portion of its proposal which would have permitted nonexchange traded issuers to take advantage of the liberalized use of Form S-3.

Thus, nonexchange-traded issuers are in the same position as they currently are with respect to the utilization of the Form S-3 for resale of previously issued shares—they will continue to be unable to utilize Form S-3.

The principal requirement to permit exchange traded issuers with a less than $75 million public float to utilize Form S-3 for a primary offering is that the offering can be for no more than one third of the issuer's public float during a rolling period of 12 calendar months. Thus, for those eligible issuers, a new avenue to avoid the need to finance through a "PIPE" is a primary shelf registration statement so that the issuer can, at opportune times, issue freely tradable stock to investors. The adoption by issuers of this financing alternative is unknown at this writing given that the effective date of these provisions was Feb. 4, 2008.

Most standards of disclosure in Regulation S-B will not change. But all "smaller reporting companies" under Regulation S-K, even former S-B issuers, must provide financial statements under Regulation S-X's new Article 8.

Shell Companies

The SEC took great pains to explicitly exclude from the benefits of the new Rule 144 and Form S-3 liberalization, so called "shell" companies and "blank-check" companies. This type of company, which the SEC has consistently viewed as being subject to speculative abuse, will not be entitled to use Form S-3 unless it meets the $75 million public float threshold, or when 12 months have passed since it was a "shell" company and when it has filed information that would be required in a registration statement on Form 10 (essentially, a 10-K). In addition, holders of restricted securities in "shell" companies will not be permitted to utilize Rule 144 at all until the company has filed "Form 10" information and one year has elapsed since that filing, and the issuer is no longer a "shell" company and has filed all Exchange Act reports for a 12-month period (other than current reports on Form 8-K).

Nixing S-B Disclosure Regime

The other significant rule-making initiative adopted by the SEC is the elimination of Regulation S-B and the importation of these rules into a newly revised regulation S-K. These rules will permit companies with under $75 million nonaffiliate public float to utilize the less-stringent standards that are currently only available to Regulation S-B issuers.

This new category of issuers eligible to use the scaled-down requirements of the new provisions of Regulation S-K are defined as "smaller reporting companies." This harmonizes the definitions to those utilized in Form S-3 to establish which issuers are subject to the expanded, but still limited utilization of that form for primary offerings (although, the new scaled down disclosure requirements will apply to Bulletin Board issuers).

Generally, most of the standards of disclosure in Regulation S-B will not change. However, all "smaller reporting companies" reporting under Regulation S-K, even former S-B issuers, will be required to provide financial statements under Regulation S-X's new Article 8, which will require two years of comparative audited balance sheet information, as opposed to the requirement under current Item 310 of Regulation S-B for only one year of balance sheet data.

Further, an issuer can choose to report, on an item-by-item basis, either the scaled disclosure requirements for smaller reporting companies or the more rigorous disclosure requirements for larger companies.

Companies qualifying as "small business issuers" under Regulation S-B had, to the extent they are calendar year-end companies, and continue to have, to the extent they have fiscal years ending later, the option to file their first annual report for their fiscal year ending on or after Dec. 15, 2007 on either Form 10-KSB or Form 10-K. After this annual report filing, all subsequent quarterly and annual reports must be filed on Form 10-Q and Form 10-K, respectively.

1. The volume limits would have, under the previously in effect provisions of Rule 144, limit sales to an amount, every three months, equal to the greater of 1 percent of the issuer's outstanding shares or the average weekly trading volume in the four weeks preceding the sale. Previously, the applicable holding period was one year, with an additional one-year period during which sales could only be made pursuant to Rule 144's volume limits and manner of sale requirements.

2. These conversion caps are frequently utilized for another purpose, namely to prevent the investor from becoming a "Section 16 filer," which would require transactional reporting on Forms 3 and 4, as well as exposing the investor to the short swing profit provisions of Section 16(b).

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