The Impact of Revised Rule 144 on Registration Rights

New York
January 31, 2008

On February 15, 2008, revised Rule 144 will take effect.[1] As detailed in our alert memo of December 31, 2007, the SEC substantially reduced the holding periods applicable to the sale of restricted securities. In particular, non-affiliates will be able to resell freely the securities of an Exchange Act-reporting company six months after issuance, so long as the issuer continues to report. After a one-year holding period, non-affiliates will be able to resell freely securities of all issuers, including non-reporting companies.

I. Are Registration Rights Still Necessary?

Whether investors will continue to seek registration rights in light of the changes to Rule 144 will depend primarily on whether they are likely to be affiliates of the issuer after the investment. In the capital markets context—where investors are unlikely to be affiliates of the issuer after the offering—the shortened holding periods under amended Rule 144 should generally eliminate the need for registration rights. Investors, however, may still insist on a covenant by a reporting issuer to remain current in its SEC filings to permit free resale after six months.

There are two key exceptions to this likely shift in capital markets practice. First, investors in private equity of public issuers (so-called "PIPEs" transactions) often require issuers to establish resale shelves at or relatively shortly following the closing of their investment. The reduced holding periods under Rule 144 are therefore unlikely to affect registration rights practice in this area. Second, registration rights will continue to be necessary where the issuer has an investment bank affiliate that is expected to be a market-maker in the offered securities.

In the private equity investment context and other circumstances where investors are, or expect to become, affiliates of the issuer following their investment, registration rights also are unlikely to be materially affected, except for their duration after investors cease to be affiliates.

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[1] *See* SEC Release No. 33-8869 (Dec. 6, 2007), 72 Fed. Reg. 71546 (Dec. 17, 2007).

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A. A/B Exchange Offers

Reporting Issuers. In an "A/B" or "Exxon Capital" exchange offer, an issuer privately places securities (generally, non-convertible debt or investment grade preferred stock) and subsequently exchanges identical securities for those restricted securities pursuant to an exchange offer registration statement. The new securities are no longer restricted because they have been issued in a registered offering. For reporting issuers, the registration rights agreement typically requires the exchange to be completed within six months of the initial issuance. Failure to comply normally results in the issuer paying additional amounts (*e.g.,* increased interest) on the securities until it complies or the securities become freely tradable.

The reduction of the holding period for a reporting issuer to six months should allow investors to accept a simple covenant to agree to continue reporting during the period from six months to one year following issuance or otherwise to pay additional amounts.[2] So long as the issuer continues to report during this period, holders will not be harmed because they will be able to freely resell their securities; if reporting ceases, the holders will be compensated.

Securities held by affiliates of an issuer and "allotment securities" (*i.e.,* securities purchased directly from the issuer and not resold to investors) held by the initial purchasers cannot be exchanged in an A/B exchange offer.[3] Accordingly, registration rights agreements typically grant initial purchasers rights to require the issuer to establish a resale registration statement under which they can sell their securities.[4] In contrast to an A/B exchange offer, a resale shelf does not result in holders having unrestricted securities that can be freely resold; rather, the holders are named as selling securityholders in the shelf registration statement and can resell their securities only under a then-current prospectus. The right to a resale shelf, however, is very seldom invoked.[5] It remains to be seen whether initial purchasers will continue to request this resale registration right when A/B exchange registration is no longer required.

Replacing registration rights with a current reporting covenant raises the question of how to calculate the additional amounts an issuer would owe if it ceased to report during the period

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[2] As an additional alternative, the issuer could agree to file a registration statement in the event that it ceases to report, but the likelihood it would be able to do so immediately on the heels of "going dark" seems remote.

[3] For additional information on the types of securities and participants eligible for A/B exchange offers, *see* Exxon Capital Holdings Corporation (avail. May 13, 1988); Morgan Stanley & Co. Incorporated (avail. June 5, 1991); K-III Communications Corporation (avail. May 14, 1993); Shearman & Sterling (avail. July 2, 1993); and Brown & Wood LLP (avail. February 7, 1997).

[4] Affiliates generally do not purchase securities in the typical capital markets transaction involving the sale of restricted securities. *See* Note 12 below.

[5] There likely are several reasons this right is rarely exercised. First, reselling under a resale registration statement would subject the initial purchasers to potential liability under Sections 11 and 12(a)(2) of the Securities Act, in contrast to resales under Rule 144A, which do not. Second, the initial purchasers may not wish to impose the incremental expense of a resale registration statement on the issuer, particularly when the need arises from the initial purchasers' failure to sell allotment securities.

between six months and one year after issuance. Under the typical A/B exchange registration rights agreement, this amount is readily determinable because it turns simply on whether or not the issuer fails to carry out the exchange offer. Under a continued reporting covenant approach, however, determining the amount of restricted securities on which additional amounts should be paid is not so simple because securities may have been sold after six months but before the issuer goes dark, and thus become unrestricted securities. Tracking these unrestricted securities would require establishing a separate global security (and CUSIP) for them.

Providing for the automatic settlement of sales of restricted securities in this new unrestricted global security unless and until the issuer goes dark would be one easy way to differentiate between restricted and unrestricted securities. There may be technical impediments to implementing this solution, however, as DTC does not presently appear to be capable of monitoring such trades and reporting them to the registrar and transfer agent for appropriate adjustments to the global securities to be made. The technical and administrative burden of implementing such a solution also would seem unjustified given the relative improbability of issuers going dark between six and twelve months.

In addition, creating two global securities during this period is undesirable for both issuers and investors because it would result in two non-fungible pools of securities, which could well have adverse effects on liquidity and pricing. Issuers therefore may be willing to accept the risk of paying additional amounts on all outstanding securities, both because the likelihood of this cost materializing is remote and because issuers no longer will have to pay the cost of registering the securities.[6]

Non-Reporting Issuers. Non-reporting issuers generally require lead time to prepare for Exchange Act reporting and commit to carry out an A/B exchange offer only one year (or sometimes more) following closing. Since non-affiliate holders will be able to resell their securities freely under revised Rule 144 by that time, registration rights would appear unnecessary (subject to the position taken by initial purchasers regarding the resale of unsold allotment securities, as described above).

Even though registration rights may no longer be required for holders to have freely tradable securities one year after issuance, it is possible investors would continue to insist on registration to force the issuer (particularly in the domestic high yield market) to comply with SEC reporting requirements and the investor protections imposed on public companies by the Sarbanes-Oxley Act of 2002. It remains to be seen whether issuers will be willing to incur the

[6] As discussed in our December 31, 2007 alert memo, we believe the legend on the initially issued restricted global security should be removed only after one year, not six months. In the adopting release for revised Rule 144, the SEC indicated that the removal of the legend remains a matter solely in the discretion of the issuer, and that disputes about the removal of legends are governed by state law and contractual agreements. However, the SEC also indicated that it would not object if issuers removed restrictive legends from securities held by non-affiliates after all applicable Rule 144 conditions are satisfied. Given the continued reporting condition for reporting issuers, the earliest time at which all applicable Rule 144 conditions will be satisfied (for any issuer) is one year following the issuance of the securities. Nonetheless, it is possible to craft a legend that recognizes the unrestricted nature of the securities between months six and twelve (assuming the issuer continues to report), yet also reimposes appropriate restrictions if it goes dark during this period.

burden—in both management time and out-of-pocket-costs—that compliance with Sarbanes-Oxley entails or whether investors will be willing to rely on information-furnishing covenants specifying the financial and related information investors need to monitor their investment.

B. Convertible Bonds

A/B exchange offers generally cannot be used in connection with private placements of convertible bonds.[7] Usually, however, the issuer enters into a registration rights agreement committing to establish a resale registration statement that allows holders to resell their bonds on an SEC-registered basis. As in the case of A/B exchange registration, issuers typically agree to establish resale registration shelves within six months of closing. Issuers also agree to keep these registration statements effective until the securities can be sold without restriction under Rule 144 (*i.e.,* prior to the recent amendments, until two years following issuance). Again, failure to comply results in additional amounts being owed on the securities.

In these circumstances, the reduction of the holding period to six months for a reporting issuer should allow investors to accept the continued reporting covenant approach outlined above.[8] For non-reporting issuers, which customarily would not have had to establish a resale shelf registration statement until one year after issuance, registration rights would again appear unnecessary.[9]

C. PIPEs

Registration rights are an integral part of the PIPEs landscape, where investors typically wish to ensure the availability of a resale registration statement within 60 to 90 days (and sometimes less) of the closing of their investment. As noted above, the reduced holding period under Rule 144 is unlikely to affect registration rights practice in this area.

D. Private Equity Investments

Under revised Rule 144, affiliates will still be subject to limitations on the volume of securities they may sell and, in the case of equity securities, the manner of sale. Accordingly,

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7 In certain circumstances, the SEC has allowed foreign private issuers to carry out A/B exchange offers involving common stock and securities convertible into common stock. *See, e.g.,* Vitro, Sociedad Anónima (avail. November 19, 1991); Transportación Maritima Mexicana, S.A. de C.V. (avail. June 8, 1992); Corimon C.A. S.A.C.A. (avail. Mar. 22, 1993); Grupo Financiero InverMexico (avail. April 4, 1995).

8 The typical resale registration rights agreement allows the issuer to suspend the availability of the resale registration statement if the resale prospectus becomes inaccurate or misleading because of material developments the issuer would prefer to remain confidential. If the shelf is unavailable for more than a set time (*e.g.,* 45 days out of any 90-day period), then additional amounts must be paid. Issuers, however, should not need this so-called "black-out" relief under a continued reporting covenant because investors are able to resell their securities without regard to whether a current prospectus is available.

9 Most Rule 144A convertible bond issuers already are reporting issuers. A reporting issuer may elect to rely on Rule 144A to achieve faster execution than an SEC-registered offering would permit or to take advantage of the exemption from Regulation M for Rule 144A transactions because the issuer plans to carry out a concurrent buyback of its common stock.

private equity investors in a non-reporting issuer will generally still insist on obtaining registration rights if they will be affiliates of the issuer because of the large size of their investment or their representation on the board of directors.

Private equity investors commonly finance their acquisitions in part through private placements of high yield bonds issued by the acquired companies. As noted above, non-reporting issuers generally commit to carry out an A/B exchange offer within one year of closing, and may well be able to forego granting registration rights altogether. If, however, the issuer is affiliated with one or more of the initial purchasers making a market in the bonds—because a financial institution was part of the consortium that acquired the issuer and one of its affiliates is placing the bonds—then the bonds would not be freely tradable one year after issuance. This is because purchases and sales in connection with the market-making activity would “taint” the pool of outstanding restricted bonds, effectively restarting the Rule 144 holding period. Even if the issuer established an effective shelf with a market-making prospectus one year after issuance, investors could be required to wait as much as an additional six months to be able to resell freely (resulting in a potential total holding period of 18 months). If investors are unwilling to wait for this additional period, they will insist that the issuer carry out an A/B exchange offer within the customary one-year timeframe.[10] If the A/B exchange is done, it also should be relatively easy for the issuer to provide the affiliated financial institution with a prospectus to support ongoing market-making in the registered bonds.[11]

II. How Should Existing Registration Rights Agreements be Interpreted?

Registration rights agreements ordinarily obligate issuers to keep resale registration statements effective until all the restricted securities covered by the agreement (i) have been sold pursuant to a registration statement, (ii) have been resold under Rule 144 (*i.e.,* pursuant to its volume and manner of sale provisions), (iii) are no longer outstanding or (iv) may be resold pursuant to Rule 144(k) or any successor thereto. Although the recent amendments to Rule 144 will eliminate Rule 144(k), the provision of new Rule 144(d) permitting non-affiliated holders to resell without any conditions after one year is clearly the successor to Rule 144(k). Even where registration rights agreements do not explicitly contain the phrase “or any successor thereto,” we believe references to Rule 144(k) should be construed as referring to the reduced one-year holding period under the revised rule. An issuer with an existing resale registration statement where the relevant restricted securities have been outstanding for more than one, but less than

[10] Investors also might insist on an A/B exchange offer in order to prevent the creation of two non-fungible pools of securities, one restricted and another (having been resold through the affiliated market-maker under its resale registration statement) unrestricted, as well as to avoid having to sell their still-restricted securities through the affiliated market-maker in order to deliver unrestricted securities to purchasers.

[11] In addition to the PIPEs and affiliated market-maker contexts, it is possible that certain investors, such as insurance companies or investment funds, may request registration rights in light of legal or contractual investment restrictions to which they are subject. Because restrictions of this sort come from a wide variety of regulatory and contractual sources, determining the extent of any such restrictions is beyond the scope of this memo.

two, years therefore should be able to conclude that it is no longer obligated to maintain its shelf.[12]

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Questions regarding revised Rule 144 and registration rights can be directed to your regular contacts at the firm or to any of our partners and counsel listed under Capital Markets in the "Our Practice" section of our web site, http://www.clearygottlieb.com.

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[12] Issuers in these circumstances also will have to ensure that none of their affiliates has purchased and resold the relevant securities, which would "taint" the outstanding restricted securities, as described above. Comfort on this score should be easily obtained, however, because it is standard for purchase agreements to contain a covenant from the issuer that it will not, and will not permit any of its affiliates to, resell such securities.

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