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The SEC's December 2007 Rule Revisions: Updates to Standard Transaction Documentation for Financial Intermediaries (Part 1)

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(This is the first of a two-part series of articles discussing the SEC's revisions to Rule 144, Forms S-3 and F-3, and reporting requirements for smaller companies. The concluding part of this series will be published in our May issue.)

In December 2007, the SEC released the final versions of important rule revisions relating to Rule 144, Form S-3/F-3 eligibility, and reporting requirements of "smaller reporting companies."

This article is principally intended to alert financial intermediaries to some of the changes that they might consider making to their principal standard transaction documents and forms as a result of these amendments. As to a variety of these provisions, we will set forth proposed revised language and provisions, which are indicated with marked text.[1]

This article will summarize the amendments, and discuss potential revisions to underwriting agreements, placement agency agreements and related offering documents. In next month's issue, we will discuss changes to registration rights agreements and related provisions in PIPEs and other private placements, and we will also discuss documentation changes in connection with sales of Rule 144 "restricted securities" and broker-dealer compliance manuals.

Summary of the Amendments

We begin with a brief summary of the December 2007 amendments:

Rule 144[2] — Rule 144 permits public resales of (a) securities acquired directly from an issuer in non-registered transactions (referred

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to as "restricted" securities) and (b) unrestricted securities held by affiliates of the issuer (referred to as "control" securities). In each case, if the requirements of the rule are satisfied, the resales may be made without SEC registration. These requirements have included limitations of the number of shares that can be sold in any three-month period, manner-of-sale restrictions and, in the case of restricted securities, a minimum holding period of one year before any resales may be made under the rule. Planning resales in compliance with Rule 144 is a key consideration in a variety of private placements, including PIPEs and Rule 144A offerings.

The amendments relax the restrictions of Rule 144 relating to the resale of restricted securities by:

- reducing the minimum holding period for restricted securities issued by reporting companies from one year to six months;
- permitting persons who have been non-affiliates of a reporting issuer for at least 90 days to sell unlimited amounts of restricted securities after a six-month holding period, as long as the issuer meets Rule 144's current public information requirement, and to sell restricted securities without any conditions after a one-year (as opposed to the prior two-year) holding period; and
- eliminating the Form 144 notice requirement for sales by non-affiliates and increasing the thresholds that trigger the Form 144 filing requirement for proposed sales by affiliates.

Short Form Registration[3] – As to Form S-3 and Form F-3, the amendments will enable a company that has less than $75 million in public equity float to register its primary securities offerings on one of these forms if it:

- meets the other eligibility requirements of the relevant form;
- is not and has not been a "shell company" for at least 12 calendar months prior to the filing of the form;
- has a class of common equity securities listed on a national securities exchange[4]; and
- does not sell in a 12-month period more than the equivalent of one-third of its public float.

Registration of securities offerings on one of these short forms is potentially very desirable to companies. In particular, these forms permit the incorporation by reference of Exchange Act filings made after the effective date of the registration statement, so that updating the registration statement is generally not required. Shelf offerings may be effected using one of these forms, enhancing the ability of a company to rapidly access capital when a "market window" is open.

Smaller Reporting Companies[5] — Finally, the amendments relax certain SEC reporting requirements in registration statements and Exchange Act filings for companies with a public float of less than $75 million, creating a new category called "smaller reporting companies."

Revisions to Underwriting Agreements, Placement Agency Agreements and Related Offering Documents

Representations and Warranties — In the case of registration statements on Form S-3 or F-3, these sections of underwriting agreements, placement agency agreements and purchase agreements may be updated to more appropriately state the basis upon which the issuer qualifies to use the relevant form for registration, and that the relevant conditions set forth in the revised rules are satisfied. Revisions of this kind will enhance the precision of the representations and warranties in light of the new eligibility rules, and potentially bolster the underwriters' or placement agents' due diligence defense.

These representations may be revised to add statements that (a) the relevant offering, combined with other short-form offerings registered under the new rules, do not exceed one-third of the issuer's public float, and (b) the issuer has not been a "blank-check" company during the preceding year. In addition, where an issuer's disclosures are "scaled" in accordance with the new requirements for smaller reporting companies, the issuer may represent explicitly that it qualifies for the more lenient treatment.

Model Language:

Prior to the adoption of the new eligibility requirements, a standard form of representation provided by an issuer in an underwriting or similar agreement for an offering registered on Form S-3 or F-3 would have read as follows:

"The Company satisfies all of the requirements of the Securities Act for use of Form S-3 (F-3) for the offering of the [Shares] contemplated hereby."

After the new eligibility requirements are effective, this representation may be set forth differently, depending upon the nature of the relevant issuer:

a. For companies that satisfy the short-form eligibility requirements based on a public float of at least $75 million: "The Company satisfies all of the requirements of the Securities Act for use of Form S-3 (F-3) for the offering of the [Shares] contemplated hereby, *including the transaction requirements set forth in General Instruction I.B.1.*[6] *of such form."* (emphasis added)

b. For smaller reporting companies that only qualify for short-form registration as a result of the new eligibility requirements: "The Company satisfies all of the requirements of the Securities Act for use of Form S-3 (F-3) for the offering of the [Shares] contemplated hereby, *including the transaction requirements set forth in General Instruction I.B.6.*[7] *of such form. The aggregate market value of all securities sold by or on behalf of the Company pursuant to Form S-3 (F-3) during the period of 12 calendar months immediately prior to, and including, the offering contemplated hereby is no more than one-third of the aggregate market value [worldwide]*[8] *of the voting and non-voting common equity held by non-affiliates of the Company, all as contemplated by General Instruction I.B.6.(a)*[9] *of such form. The Company is not a shell company (as defined in Rule 405 under the [Securities] Act, and has not been a shell company for at least 12 calendar months prior to the filing of the Registration Statement."*[10] (emphasis added)

Additional representation for issuers that utilize the "scaled disclosure rules": "The Company is a "smaller reporting company," as defined in Rule 405 under the [Securities] Act."[11]

Legal Opinions – In the case of registration statements on Form S-3 or F-3, the required legal opinions may be updated to more appropriately state the basis u[on which the issuer qualifies to use the relevant form for registration, and that the relevant conditions set forth in the revised rules are satified.

Model Language:

To date, in connection with offerings registered on Form S-3 or F-3, underwriters have typically requested from issuer's counsel (and often, underwriters' counsel as well) an opinion to the following effect:

"The conditions to the use of Form S-3 (F-3) in connection with the offering and sale of the [Shares] as contemplated by the Underwriting Agreement have been satisfied."

This opinion has historically been understood to implicitly opine that the issuer had the required public equity float to use Form S-3 or F-3 for a primary offering.

The following opinion language is suggested for offerings occurring after the effective date of the new eligibility rules. Underwriters may also expect certain additional qualifications and opinion practice procedures from counsel, as described below.

a. Issuers that Satisfy the Short-Form Eligibility Requirements Based on a Public Float of at Least $75 Million:

Opinion Language: "The conditions to the use of Form S-3 (F-3) in connection with the offering and sale of the [Shares] as contemplated by the Underwriting Agreement, *including the transaction requirements set forth in General Instruction I.B.1. of such form*, have been satisfied." (emphasis added)

Opinion Procedures[12]: Unless the calculation is manifestly obvious to a reader of the issuer's offering documents, counsel may seek a certification from the issuer with substantially the following language: "The aggregate market value [worldwide][13] of the Company's voting and non-voting common equity held by non-affiliates[14] of the Company was $_____[15] as of _____, 20__.[16]

b. Smaller Reporting Company Issuers Relying on New General Instruction I.B.6. of Form S-3 or I.B.5 of Form F-3:

Opinion Language: "The conditions to the use of Form S-3 (F-3) in connection with the offering and sale of the [Shares] as contemplated by the Underwriting Agreement, *including the transaction requirements set forth in General Instruction I.B.6.*[17] *of such form, have been satisfied."* (emphasis added)

Additional Opinion Qualification Language: In rendering the opinion set forth in paragraph ___ above, we have relied upon the Company's [representations and warranties set forth in Section ___ of the [Underwriting Agreement] and the] statements set forth on the outside front cover of the [Prospectus] pursuant to General Instruction I.B.6.¶7[18] of Form S-3 (F-3).

Opinion Procedures: The additional language for the officer's certificate described above for a smaller reporting company may not be necessary in this instance, due to the opinion's explicit reliance on the representations in the underwriting agreement and the new statement in the prospectus described in the preceding paragraph. If such a representation is not given in the underwriting agreement, consideration may be given as to whether it should be added to an officer's certificate delivered to counsel in connection with counsel's issuance of its opinion.

Additional opinion language for issuers that utilize the "scaled disclosure rules": it is likely that underwriters will expect counsel to render an opinion in substantially the form of the representation provided above as to the issuer's status as a "smaller reporting company."

Indemnification — In connection with the one-third cap, the amendments to Form S-3 and Form F-3 also revise the rules under the Securities Act to provide that a violation of this restriction will also violate the requirements for using the proper registration form, even though the relevant registration statement has already been declared effective. The SEC has amended Rule 401(g) ("Requirements as to Proper Form") to add an additional provision stating that violations of General Instruction I.B.6 of Form S-3 or General Instruction I.B.5 of Form F-3 (including violation of the one-third cap) violates the requirements as to proper form under Rule 401, even though the registration statement may have been previously declared effective. However, the remedy for such a violation is not indicated by the new rules. Accordingly, underwriters may seek to revise the indemnification provisions of their underwriting and similar agreements to reflect the possibility of liability when the issuer is relying on the new eligibility rules in connection with the offering.

Model Language:

The following is a proposed revision to a somewhat standard form of indemnification provision for an underwritten offering:

The Company shall indemnify and hold harmless each Underwriter and each person, if any, who controls any Underwriter within the meaning of Section 15 of the Securities Act or Section 20(a) of the Exchange Act, against any and all losses, liabilities, claims, damages and expenses whatsoever as incurred (including but not limited to attorneys' fees and any and all expenses whatsoever incurred in investigating, preparing or defending against any litigation, commenced or threatened, or any claim whatsoever, and any and all amounts paid in settlement of any claim or litigation), joint or several, to which they or any of them may become subject under the Securities Act, the Exchange Act or otherwise, insofar as such losses, liabilities, claims, damages or expenses (or actions in respect thereof) arise out of or are based upon (i) any untrue statement or alleged untrue statement of a material fact contained in the Registration Statement, as originally filed or any amendment thereof, or any related preliminary prospectus or the Prospectus, or in any supplement thereto or amendment thereof, or (ii) arise out of or are based upon the omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading**, or (iii) arise out of or are based upon any failure of the Registration Statement to comply with General Instruction I.B.6.[19] of Form S-3 (F-3);**

Comfort Letters — Smaller reporting companies are no longer required to have financial statements that comply with all of the provisions of SEC Regulation S-X; instead, their financial statements will be principally regulated solely by GAAP.[20] Accordingly, it may be appropriate to discuss with the applicable issuer's auditors at the outset of an offering the basis on which the issuer's financial statements have been prepared, and whether the proposed "form of" language of the comfort letter set forth in an underwriting or similar agreement is consistent with that approach.[21]

Lock-up Agreements — As a result of the amendments to Rule 144, after a six-month holding period, non-affiliates will have the ability to resell shares of the issuer without regard to the Rule 144 volume limitations.[22] Accordingly, underwriters may seek to consider whether it is appropriate for IPO and/or follow-on offerings to be followed by lock-up periods for some or all of the relevant stockholders that exceed the existing six-month/three-month "standard" periods. In addition, with respect to many IPOs, underwriters may be more inclined to ensure that all pre-IPO stockholders are subject to lock-up agreements, as opposed to only locking up those stockholders who have holdings which exceed a certain percentage. Changes of this kind may help prevent substantial resales of the pre-IPO stock in the market after the IPO.

Model Language:

The following is a proposed revision to a somewhat standard form of "lock-up" condition for an underwritten offering:

The Company shall have obtained for the benefit of the Underwriters the agreement (a "Lock-Up Agreement"), in the form set forth as Exhibit A hereto, of each of its directors, "officers" (within the meaning of Rule 16a-1(f) under the Exchange Act) and ~~stockholders holding of record or beneficially at least [5%~~ each stockholder [, warrantholder and optionholder] of the Company~~'s outstanding shares of Common Stock~~ as of the date hereof.

Prospectus Disclosure as to "Shares Held for Future Sale" — In this area, the onus of the drafting will probably be on issuer's counsel, as opposed to the underwriters and their counsel. However, underwriters should be careful to ensure that prospectus disclosure relating to the resale of restricted shares into the market after the offering is revised to conform to the terms of the Rule 144 amendments.

Model Language:

The following is a sample set of revisions to this section of the typical IPO prospectus:

Rule 144

In general, under Rule 144 as currently in effect, starting 90 days after the date of this prospectus, a person or persons whose shares are aggregated, who have beneficially owned restricted shares for at least ~~one year, including persons~~ **six months, and** who ~~may be deemed to be~~ **is or** are our "affiliates," would be entitled to sell within any three-month period a number of shares that does not exceed the greater of:

- 1.0% of the number of shares of common stock then outstanding, which will equal approximately X shares immediately after this offering; or
- the average weekly trading volume of our common stock on the [New York Stock Exchange] during the four calendar weeks before a notice of the sale on Form 144 is filed with the SEC.

Sales under Rule 144 are also subject to certain manner of sale provisions and notice requirements and to the availability of certain current public information about us.

Under Rule ~~144(k),~~**144,** a person who is not deemed to have been an "affiliate" at any time during the 90 days preceding a sale, and who has beneficially owned the shares proposed to be sold for at least ~~two years~~ **six months**, including the holding period of any prior owner other than an "affiliate," is entitled to sell these shares without complying with the manner of sale, ~~public information,~~ volume limitation or notice provisions of Rule 144. **After the shares are beneficially held for at least one year, these sales would also be no longer subject to the current public information provision.**

NOTES

1. Of course, we note that many forms and provisions are used in today's capital markets transactions. Accordingly, we have limited ourselves to providing representative samples, as opposed to identifying and modifying an extensive number of provisions used under similar circumstances.
2. The SEC's adopting release for its amendments to Rule 144 may be found at: http://www.sec.gov/rules/final/2007/33-8869.pdf.
3. The SEC's adopting release for its amendments to the Form S-3 and Form F-3 eligibility requirements may be found at: http://www.sec.gov/rules/final/2007/33-8878.pdf.

4. The term "national securities exchange" does not include the "Over-the-Counter Bulletin Board" or the "Pink Sheets."
5. The SEC's adopting release for "Smaller Reporting Company Regulatory Relief and Simplification" may be found at: http://www.sec.gov/rules/final/2007/33-8876.pdf.
6. This instruction number is the same in both Form S-3 and Form S-3.
7. For Form F-3, this reference should be to General Instruction I.B.5(a).
8. Add the word "worldwide" here for Form F-3.
9. For Form F-3, this reference should be to General Instruction I.B.5(a).
10. If the final sentence is not correct, the representation should be modified to reflect General Instruction I.B.6(b) of Form S-3, or General Instruction I.B.5(b) of Form F-3, as applicable. As mentioned above, it is also a requirement that the registrant have at least one class of common equity securities listed on a national securities exchange (i.e., not the OTC-BB or the "Pink Sheets"); that requirement has not been added here as a representation, as the relevant information is readily available in the public domain.
11. Under Rule 405, the determination as to whether a company is a "smaller reporting company" is made for purposes of Exchange Act reporting based upon its public float as the last business day of the second quarter in the prior fiscal year. Accordingly, it is possible that, in some cases, the Exchange Act filings incorporated by reference in a Form S-3 or F-3 will be based upon the disclosures made at a time when the registrant was a smaller reporting company, but no longer is one. Accordingly, in some cases, it may be appropriate to modify this representation with an initial qualifier, such as, *"at the time that it filed its Form 10-K, Form 10-Q and definitive proxy statement on Schedule 14A in the year ended December 31, 20[07],* the Company was a "smaller reporting company," as defined in Rule 405 under the [Securities] Act." (emphasis added).
12. These procedures should supplement counsel's existing procedures for confirming Form S-3/F-3 eligibility. These procedures should include verification of the timely filing of the issuer's periodic reports as required by the General Instructions to Forms S-3 and F-3, and the absence of any failure to pay a dividend or a material default in repayment of indebtedness, as contemplated by such General Instructions. Depending upon the circumstances, additional representations or warranties upon which counsel may rely, or officer certifications to counsel, may be required.
13. Add the word "worldwide" here for Form F-3.
14. Due to the lack of certainty as to the definition of "affiliate," underwriters and attorneys will need to carefully review the issuer's "principal stockholder table" and relevant Schedule 13D and 13G filings, and assess whether it is reasonable to rely on this representation.
15. Of course, this number must equal or exceed $75.0 million.
16. This date must be within 60 days prior to the initial filing date of the registration statement.
17. For Form F-3, this reference should be to General Instruction I.B.6.
18. For Form F-3, this reference should be General Instruction I.B.5.¶7. This new disclosure requirement mandates that companies relying on the new eligibility rules set forth the public equity float and the amount of securities sold in reliance on the new rules on the front cover of the relevant prospectus supplement.
19. For Form F-3, this reference should be to General Instruction I.B.5.
20. See new Rule 8-01 of Regulation S-X.
21. Please note that our own initial discussions with auditing firms suggest that they will not distinguish between smaller reporting companies and other issuers, as their responsibilities will generally not change under the applicable auditing standards.
22. Revised Rule 144(b)(1)(i). However, they will be subject to Rule 144's "current information" requirement until the expiration of a one-year holding period.