Small Business Securities Newsletter

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Recent SEC Proposals Would Greatly Benefit Smaller Public Companies

By Vincent A. Vietti and Lauren W. Taylor

The Securities and Exchange Commission (SEC) recently proposed sweeping changes to modernize and improve capital raising and reporting requirements, particularly for smaller public companies. If approved, the rules would:

- permit all public companies to use Form S-3 to file a shelf registration statement to offer securities directly to the public
- reduce the holding periods for restricted securities issued in private placement transactions from one and two years to six months and one year, respectively
- simplify and provide for Form D to be filed electronically

If adopted, the rules would have a positive impact on smaller public companies by: (i) providing the ability to access the capital markets more quickly by offering free trading securities directly to investors; and (ii) reducing the time and expense of completing private placement transactions. Although the public comment period for the proposed rules ended this month, final rules are not expected until year end or early 2008.

Form S-3 Available for Primary Offerings by Smaller Public Companies

Form S-3 is the short form used by issuers to register securities offerings under the Securities Act of 1933 (the Securities Act). Currently, issuers must have a public float (market value of shares held by non-affiliates) of at least $75 million in order to use Form S-3 to register offerings directly to investors (primary offering). Form S-3 allows issuers to incorporate required disclosure by reference to quarterly, annual, and current reports previously filed with the SEC under the Securities Exchange Act of 1934 (the Exchange Act) and provides for automatic updating of the registration statement by incorporating future reports filed under the Exchange Act. By contrast, companies that are not eligible to use Form S-3 must update information by filing a new registration statement or a post-effective amendment to a previously filed registration statement, which then must be reviewed and declared effective by the SEC before securities may be sold.

The proposed amendments would make the short-form registration statement available for primary offerings by smaller public companies. Under the proposed amendments, issuers with less than $75 million of public float could use Form S-3 to register primary offerings so long as:

- they satisfy the other eligibility requirements of the form (including timely filing of all reports due under the Exchange Act during the 12 months preceding the filing of the registration statement)
- they are not a shell company and have not been a shell company for at least 12 months before filing the registration statement
- sales of securities do not exceed 20 percent of their public float over any 12-month period

This will permit companies quoted on the OTC Bulletin Board® (OTCBB) to use Form S-3 to engage in continuous at-the-market offerings of their securities directly to the public, as long as they are able to satisfy the issuer eligibility requirements of Form S-3. As proposed, Form S-3 will remain unavailable to OTCBB issuers for secondary or selling-shareholder registrations. If adopted, smaller public companies that otherwise satisfy the eligibility requirements of the form will be able to use Form S-3 to conduct primary offerings "off the shelf" under Rule 415 of the Securities Act. This will permit smaller public companies to register securities offerings prior to planning any specific offering and, once the registration statement is effective, offer securities in one or more tranches directly to the public as market conditions warrant without further SEC action.

Currently, smaller public companies that are not eligible to use Form S-3 must first privately place their securities and then file a Form S-1 to permit the public resale of the

privately placed shares. By eliminating the delay between the closing of the private placement and effectiveness of the Form S-1, which is typically 60-90 days or more, and providing smaller public companies with more control over the timing of their offerings, it is expected that they will be able to raise capital on more favorable terms. For example, the liquidity discount normally built into the price of restricted shares should be reduced or even eliminated for shares sold "off the shelf." We expect that most smaller public companies in need of capital will file shelf-registration statements on Form S-3 soon after this proposal is adopted.

Reduced Holding Periods Will Simplify the Resale of Unregistered Securities Under Rule 144

Rule 144 was promulgated to provide a safe harbor from the registration requirements of the Securities Act for certain sales of restricted and control securities. Restricted securities are securities acquired in unregistered, private sales from the issuer or from an affiliate of the issuer typically pursuant to private placement offerings, acquisition transactions, employee stock benefit plans, or compensatory arrangements with service providers. Control securities are those held by an affiliate (directors, officers, and controlling shareholders) of the issuing company. Currently, affiliates and non-affiliates may sell restricted securities of an issuer that satisfies the current public information requirements if the securities have been held for one year and sales are made in compliance with the manner of sale, volume limitations, and Form 144 filing requirements. A person who has not been an affiliate of the issuer for at least three months and has held restricted securities for two years may sell securities without limitation.

The proposed amendments to Rule 144 would reduce the current one- and two-year holding periods for restricted securities of public companies to six months and one year. This proposal would make it substantially easier for most security holders to resell restricted and control securities. The proposed amendments would reduce the holding periods for restricted securities based on: (i) the reporting status of the issuer; and (ii) the affiliate status of the selling shareholder as follows:

- **Non-Affiliate Selling Securities of a Reporting Company**. The proposed rule would permit a person who has not been an affiliate of the issuer for the prior three months to resell restricted securities of companies that file reports under the Exchange Act after a six-month holding period as long as the issuer has filed all reports required under the Exchange Act (other than 8-K reports) during the 12 months preceding such sale. The proposed rule would eliminate the volume limitations, manner of sale requirements, and Form 144 filing requirements. After satisfying a one-year holding period, sales can be made without restriction.
- **Non-Affiliate Selling Securities of a Non-Reporting Company**. The proposed rule would permit a person who has not been an affiliate of the issuer for the prior three months to resell restricted securities of companies that do not file reports under the Exchange Act after a one-year holding period without restriction.
- **Affiliate Selling Securities of a Reporting Company**. The proposed rule would permit affiliates to resell restricted securities of companies that file reports under the Exchange Act after a six-month holding period as long as the issuer has filed all reports required under the Exchange Act (other than 8-K reports) during the 12 months preceding such sale, and the affiliate complies with the volume limitations, manner of sale requirements, and Form 144 filing requirements.
- **Affiliate Selling Securities of a Non-Reporting Company**. The proposed rule would permit affiliates to resell restricted securities of companies that do not file reports under the Exchange Act after a one-year holding period as long as there is publicly available current information about the issuer, and the affiliate complies with the volume limitations, manner of sale requirements, and Form 144 filing requirements

The SEC proposes to toll the holding period for both affiliates and non-affiliates for up to an additional six months if the security holder has engaged in certain transactions, including short sales and other "put equivalent" transactions, to hedge the market risk of its restricted security holding in order to ensure that the security was being held for investment purposes and not for distribution. The tolling, however, would not extend the aggregate holding period beyond one year. The proposed rule would also increase the Form 144 filing thresholds from sales of 500 shares or $10,000, to sales of 1,000 shares or $50,000. Finally, the proposed rule would codify seven staff positions issued by the SEC's Division of Corporation Finance over the years. These include rules relating to tracking of holding periods, cashless exercise of options and warrants, aggregation of pledged securities, and treatment of securities issued by shell companies.

By substantially reducing the holding period for investors in private placements, the SEC is seeking to increase the liquidity of privately placed securities and decrease the cost of capital for all issuers. For example, the shorter holding period may eliminate the time and expense of filing a resale registration statement and reduce the liquidity discount in certain private placements. We expect that the proposed rule will have a positive impact particularly on smaller public companies that are in need of additional capital.

SEC Proposal Will Lessen the Burden of Form D Filings

The SEC also proposes to simplify, restructure, and require the electronic filing of Form D, the notice filing required for companies that sell securities in private offerings in reliance on the exemption from registration under the Securities Act provided by Regulation D. The proposed electronic filing system would decrease the time and expense associated with Form D preparation and filing, reduce administrative errors, and improve public access to the private offering information provided in the thousands of Form D filings made each year.

The Form D has been simplified to eliminate the separate state signature page and to incorporate into the signature block a consent to service of process currently in Form U-2, which many states require to be filed with the Form D. The SEC is hopeful that the combination of Internet availability for all Form D filings and inclusion of a Consent to Service of Process will prompt state regulators to eliminate the need for issuers to make duplicate filings. Although this will not eliminate any fees required by states, it should lessen the burden of state securities law compliance in connection with private placement transactions.

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Securities Practice Area Attorneys

Jeffrey H. Nicholas*	215.918.3639 or 609.895.6705	jnicholas@foxrothschild.com
Stephen Brill	609.896.4573	sbrill@foxrothschild.com
Loren David Danzis	215.918.3561	ldanzis@foxrothschild.com
Curtis L. Golkow	215.299.2747	cgolkow@foxrothschild.com
David A. Gradwohl	215.661.9406	dgradwohl@foxrothschild.com
Kevin M. Granahan	610.458.4970	kgranahan@foxrothschild.com
Michael S. Harrington	610.458.4957	mharrington@foxrothschild.com
David A. Jaffe	412.391.6410	djaffe@foxrothschild.com
Michael J. Kline	609.895.6635 or 215.299.2791	mkline@foxrothschild.com
Peter W. Laberee	609.896.7657	plaberee@foxrothschild.com
Matthew H. Lubart	609.895.6749	mlubart@foxrothschild.com
Gregory A. Petroff	609.895.6747	gpetroff@foxrothschild.com
Abraham C. Reich	215.299.2090	areich@foxrothschild.com
Bradley S. Rodos	215.299.2180	brodos@foxrothschild.com
Elizabeth D. Sigety	215.918.3554	esigety@foxrothschild.com
Lauren W. Taylor	215.218.3625	lwtaylor@foxrothschild.com
Vincent A. Vietti	609.896.4571	vvietti@foxrothschild.com

**Practice Area Chair*

Fox Rothschild LLP
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