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The Section 4(a)(1) And 4(a)(1½) Exemption; Recommendations For An Amendment To Rule 144 Related To Shell Companies

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What are the Section 4(a)(1) and Section 4(a)(1½) exemptions, and how do they work?

Section 4(a)(1) of the Securities Act of 1933 ("Securities Act") provides an exemption for a transaction "by a person other than an issuer, underwriter, or dealer." Rule 144 provides a non-exclusive safe harbor for the sale of securities under Section 4(a)(1). In the event that Rule 144 is unavailable, a holder of securities may still rely upon Section 4(a)(1). Section 4(a)(2) of the Securities Act provides an exemption for sales by the issuer not involving a public offering. The issuer itself may not rely on Section 4(a)(1), and selling security holders may not rely on Section 4(a)(2).

Case law and the SEC unilaterally conclude that an affiliate (officer, director or greater than 10% shareholder) of the issuer may not rely on Section 4(a)(1) for the resale of securities. In particular, an affiliate is presumptively deemed an underwriter unless such affiliate meets the requirements for use of Rule 144. Rule 144, which governs both restricted and affiliate securities, defines restricted securities in relevant part as "securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving a public offering."

Accordingly, an affiliate cannot rely on Section 4(a)(1) for the resale of securities unless they meet the requirements of the Rule 144 safe harbor. The Rule 144 requirements cannot always be satisfied by an affiliate, such as when such affiliate desires to sell securities in a private transaction without the use of a broker-dealer. The court system, recognizing this gap in the statutory regime, developed the Section 4(a)(1½) exemption. When an affiliate sells a control block of a public company, they are in essence relying on Section 4(a)(1½) as no other exemption would technically be available.

Separately, in 2008, the SEC amended Rule 144 to make its use unavailable for the sale of securities initially issued by a shell company or any issuer that has, at any time, previously been a shell company unless all the requirements of Rule 144(i)(2) are met. These requirements include that the issuer no longer be a shell company, is subject to the reporting requirements of the Securities Exchange Act of 1934 ("Exchange Act") for 12 months following the time that it filed Form 10 information indicating it was no longer a shell company, and is current with all Exchange Act reporting requirements.

In an effort to gain liquidity in securities of companies that do not meet the Rule 144(i)(2) requirements due to current or former shell status, selling security holders have begun to rely directly on Section 4(a)(1), disregarding the Rule 144 safe harbor. However, as noted, Section 4(a)(1) is not available for use by affiliates, who instead rely on the Section 4(a)(1½) exemption. The same series of cases define both exemptions.

My thoughts on the Rule 144 shell company exclusion, and recommendation for a change, appear at the end of this blog.

The case law on Sections 4(a)(1) and 4(a)(1½)

As noted, Section 4(a)(1) provides an exemption for a transaction "by a person other than an issuer, underwriter, or dealer." It is generally relatively easy to determine if a person is the issuer or a dealer, leaving the question for the use of Section 4(a)(1) revolving around whether the selling security holder is an "underwriter." As further discussed herein, the same factual analysis bears on the ability to use the Section 4(a)(1½) exemption as well. Section 2(11) of the Securities Act defines an "underwriter" as any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.

Although an affiliate is presumptively an underwriter, in the event it is clear that they did not purchase with the intent to resell to the public and the purchaser is provided with appropriate information, that presumption can be overcome and a resale can be had under Rule 4(a)(1). The Court in Ackerberg v. Johnson 892 F.2d 1328 (1989) noted that:

While the term "Section 4 (1 1/2) exemption" has been used in the secondary literature... the term does not properly refer to an exemption other than Section 4(1). Rather, the term merely expresses the statutory relationship between Section 4(1) and Section 4(2). That is, the definition of an underwriter, found in Section (2)(11), 15 U.S.C. Section 77b(11)(1988), depends on the existence of a distribution, which in turn, is considered the equivalent of a public offering. Section 4(2) contains the exemption for transaction

not involving a public offering. Any analysis of whether a party is an underwriter for purposes of Section 4(1) necessarily entails an inquiry into whether the transaction involves a public offering. While the term "Section 4(1 1/2) exemption" adequately expresses this relationship, it is clear the exemption for private resales of restricted securities is Section 4(1).

In determining whether a "public offering" has been completed, practitioners rely upon the factors set-out by SEC v. Ralston Purina Co., 346 U.S. 119 (1953) and its progeny, namely, Doran v. Petroleum Management Corp., 545 F.2d 893, 900 (5th Cir. 1977) and Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 687-689 (5th Cir. 1971), and Securities Act Release No. 4552 (November 6, 1962). Those cases and the release set out relevant factors in determining whether an offering is public or private, including: (1) the number of offerees and their relationship to each other and to the issuer, (2) the number of units offered, (3) the size of the offering, and (4) the manner of the offering. We also rely on the factors set out in Cook v. Avien, Inc., 573 F.2d 685, 691 (1st Cir. 1978), wherein the court held that sales may be exempted if a private offering is made in which the purchasers (1) are limited in number, (2) are sophisticated, and (3) have a relationship with the issuer enabling them to command access to information that would otherwise be contained in a registration statement.

In determining whether securities were acquired with a view to engage in a distribution, we generally consider whether or not the securities have "come to rest" with that shareholder. This factor and its relevancy were highlighted in Ackerberg v. Johnson when the court stated, "We begin by considering whether the securities were acquired by Johnson with a view to their distribution… While this determination would at first seem to be a fact-specific inquiry into the security holder's subjective intent at the time of acquisition, the courts have considered the more objective criterion of whether the securities have come to rest. That is, the courts look to whether the security holder has held the securities long enough to negate any inference that his intention at the time of acquisition was to distribute them to the public." The court then went on to define when the securities had been held long enough to negate the inference of a distribution by citing United States v. Sherwood, 175 F. Supp. 480, 483 (S.D.N.Y. 1959): "The passage of two years before the commencement of distribution of any of these shares is an insuperable obstacle to my finding that Sherwood took these shares with a view to distribution thereof." The Ackerberg court also highlighted the two-year holding period under Rule 144 as then in effect and stated, "Many courts have accepted a two-year rule of thumb to determine whether the securities have come to rest… This two-year rule has been incorporated by the SEC into Rule 144, which provides a safe harbor for persons selling restricted securities acquired in a private placement."

The specific availability of the Section 4(a)(1½) exemption involves the added element of an affiliate shareholder seeking resale. The SEC has suggested that if an affiliate shareholder seeks to qualify for a Section 4(a)(1½) exemption to resell securities, the following elements must be satisfied: (i) resale purchasers must be solicited directly by the holder of the stock, not by the issuing entity; (ii) resale purchasers must be limited in number; (iii) resale purchasers must be provided with full disclosure of the type of information found in registration statements or Private Placement Memorandums; (iv) compliance with the purchaser qualification requirements of sophistication and ability to bear risk; and (v) the resale purchaser should make investment representations similar to those originally required by the issuer company and, in particular, that the purchaser is purchasing for investment and not with the intent to engage in a resale or distribution.

SEC Advisory Committee on Small and Emerging Companies' Recommendations on use of the Section 4(a)(1½) exemption

On March 4, 2015 and again on June 3, 2015, the SEC Advisory Committee on Small and Emerging Companies (the "Advisory Committee") met and finalized its recommendation to the SEC regarding the use of the Section 4(a)(1½) exemption from registration.

I have written about the Advisory Committee on numerous occasions, but by way of reminder, the Committee was organized by the SEC to provide advice on SEC rules, regulations and policies regarding "its mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation" as related to "(i) capital raising by emerging privately held small businesses and publicly traded companies with less than $250 million in public market capitalization; (ii) trading in the securities of such businesses and companies; and (iii) public reporting and corporate governance requirements to which such businesses and companies are subject."

The Advisory Committee unanimously approved the recommendation, which is in favor of statutorily formalizing the Section 4(a)(1½) exemption. As is true to their style, the Committee generates a short, pointed outline of their recommendations as herein summarized.

First, the committee notes that smaller public and emerging companies play a significant role in the U.S. economy and job creation. The ability of these smaller companies to raise capital is critical to U.S. economic growth. Smaller companies are better able to attract and retain key employees and executives when such employees have a viable exit strategy to monetize equity compensation. However, the JOBS Act has given private companies greater flexibility to delay going public transactions and therefore employee public liquidity events can be delayed. Although the Advisory Committee didn't elaborate

on this flexibility, I note that it is as a result of the higher shareholder thresholds before requiring registration under Section 12(g) of the Exchange Act and the ability to advertise and solicit in Rule 506(c) offering.

The Advisory Committee noted that common exemptions for the sale of securities include Section 4(a)(1) for sales by selling security holders other than an issuer, underwriter or dealer and Section 4(a)(2) for sales by the issuer not involving a public offering. Rule 144 is a safe harbor established under Section 4(a)(1). Affiliates, including key employees, often find that they don't quite fit into either exemption box and thus Section 4(a)(1½) was developed based on industry practice and case law.

Without delving into the details of the Section 4(a)(1½) exemption, the Advisory Committee concludes that it recommends that the SEC "formalize the Section 4(a)(1½) exemption to mimic existing opinion practice for resales of privately issued securities by shareholders who are not able to rely on Securities Act Rule 144."

Recommendations for an amendment to Rule 144 related to shell companies

The recent increase in reliance on the Sections 4(a)(1) and 4(a)(1½) exemption directly results from the 2008 amendment to Rule 144 making the Rule unavailable for the sale of securities initially issued by a shell company or any issuer that has, at any time, previously been a shell company. Prior to the 2008 amendments, Rule 144 was unavailable for use by the shareholders of blank check companies, but its use by shell company shareholders was unrestricted.

In its 2008 rule release the SEC addressed its reasons for the change—to wit: in an effort to curtail fraud. The SEC noted that most micro-cap frauds were the result of the purchase and sale of securities issued by shell companies. The Rule then set up conditions for use of Rule 144 by former shell companies, i.e., unless all the requirements of Rule 144(i)(2) are met. These requirements include that the issuer no longer be a shell company, is subject to the reporting requirements of the Securities Exchange Act of 1934 ("Exchange Act") for 12 months following the time that it filed Form 10 information indicating it was no longer a shell company, and is current with all Exchange Act reporting requirements.

These conditions can never be met by a non-reporting company, regardless of the availability of current information on OTC Markets through the OTC Markets alternative reporting standard and regardless of whether the company is currently a shell company or how long it has been since the company was a shell company.

The 2008 rule change had the impact of punishing a company that was ever a shell in perpetuity and more importantly, its investors. The Rule effects all companies that have ever been a shell, even if a reverse merger was completed decades ago. It paints a "scarlet letter" on all former shell companies, as this requirement continues literally forever—famous former shells like Blockbuster Entertainment, Texas Instruments and Berkshire Hathaway are now burdened by this restriction decades after their reverse mergers.

I believe this was an unintended consequence. In fact, shortly after the rule release, Brian Breheny, then deputy director of the Securities and Exchange Commission's corporate finance division, referred to the requirement in Rule 144(i) of the Securities Act as an "unfortunate result" and said it was "probably not something that the commission intended."

There have been no studies or other information related to whether the 2008 rule amendment has had the effect of curtailing fraud, but certainly it has had the effect of an increase in the use of the Sections 4(a)(1) and 4(a)(1½) exemptions. The Sections 4(a)(1) and 4(a)(1½) exemptions make no reference to the operating status of the issuer.

The Rule 144 shell company restrictions have also had the effect of dramatically reducing the ability of former shell companies to raise capital during their critical first twelve months as a public company. It is during this time period that the company is in the greatest need of capital to develop its business plan, create jobs and build a foundation for success. Certainly, the federal regulators have issued a plethora of literature addressing the need to support start-ups and infant entities and to encourage IPO's. I suspect that the regulators are concerned about the potential of fraud related to reverse mergers; however, there are better, more direct ways to address this concern than creating obstacles that affect legitimate capital raising efforts by all entities, regardless of the existence of indicia of fraud or other wrongdoing.

Although I can see the need for the codification of the Section 4(a)(1½) exemption for affiliate resale shareholders, I believe that Rule 144 should be amended to eliminate the "or any issuer that has, at any time, previously been a shell company" language. In addition, I believe that Rule 144(i)(2) should be amended to make the rule available by companies that are no longer shell companies and have current information available to the same extent that the current information requirements for non-reporting companies may be met by under Rule 144 for non-shell companies. I also advocate removing the requirement that a company be subject to the Exchange Act reporting requirements for a period of 12 months and the requirement that Form 10 information have been filed.

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In other words, I would advocate stripping down the shell company prohibition in Rule 144 such that the Rule would only be unavailable for current shell companies, perhaps with a short 30-day buffer, or former shell companies that do not meet the current information requirements appearing elsewhere in the rule. I note that this change would not affect the Item 5.06 Form 8-K requirements related to a change in shell status and rather, such “super 8-K” could be referenced as satisfying the current information requirements for reporting issuers that are between 10Q/10K filings.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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