

Restricted Securities: A Challenging Byproduct of Private Financings

In light of the development of new funding methods for startup and early stage companies, the treatment of Restricted Securities (“RS”) has assumed even greater importance. Generally speaking, RS are what purchasers receive when they invest in a securities offering that is not registered under the Securities Act of 1933 (the “Securities Act”) and/or sold pursuant to Regulation A. Examples of a non-registered offering include (but are not limited to) a traditional private placement under Regulation D, a crowdfunding offering under Regulation CF, an offering outside the US pursuant to Regulation S, or a compensatory issuance by companies to their employees and consultants under Rule 701. The different varieties of RS, each associated with different legal rules, make it necessary to consider RS on a case-by-case basis when the issue arises.

It is critical that issuers and purchasers of offerings by small and/or private companies understand the implications of selling securities characterized as RS. RS are not freely tradeable – at least initially – which is the major difference between RS and securities purchased in a public offering or on a national securities exchange.

General Nature of RS

Other than transfers pursuant to an exemption from registration under the Securities Act or for estate planning purposes, RS can usually be transferred only in compliance with Rule 144 under the Securities Act. This is the case whether the issuer of the RS is a private company or a public company at the time the RS are issued. Any securities issued by a public company are RS if they are issued in a transaction not registered with the SEC, just as if such issuer were a private company. Moreover, whether a private company issuer of RS subsequently goes public or remains private, all of its RS remain RS. In other words, if the original sale was unregistered, the securities are RS, regardless of the issuer’s subsequent status.

Failure by the issuer to restrict transfer properly can impact not only the security holder, but also subject the issuer to liability for an unregistered public offering, such as massive financial penalties and other legal sanctions, which are likely to impair its ability to raise capital through other channels.

RS must be indicated by a legend on the physical certificate with instructions to the transfer agent, if there is one. In many cases, compliance requires a formal, written opinion of reputable counsel regarding observance of applicable rules and demonstration of such observance to the transfer agent or issuer.

Rule 144 is the most frequently used safe harbor for the resale of RS. Rule 144, under most circumstances, dictates a minimum holding period, sale volume limitation pegged to public trading volume where applicable, notice of sale, issuer information availability, and manner of sale. In some cases, all restrictions disappear with the passage of a holding period. In addition to Rule 144, Rule 144A is available for sales and resales to and among financial institutions and other investors owning at least \$100 million in securities. Rule 144A also dispenses with most resale restrictions.

Contractual Aspects

Many private issuers of securities contractually impose transfer restrictions beyond the legal requirements in an effort to keep securities out of the hands of competitors, former employees, estate executors, ex-spouses, and

the like. It is important to determine in each case whether particular restrictions are needed for legal compliance, business continuity, or both.

General Considerations

Issuers and investors must keep in mind several considerations associated with RS:

- Most interests issued by companies without an effective registration statement (or Regulation A offering statement) are deemed securities and RS, regardless of how they are characterized;
- Offering documents must expressly disclose RS status and its implications, especially the legal and practical limitations on transferability;
- The specific registration exemption used must be clearly identified; for example, in a crowdfunding offering, no transfers of any kind are permitted for a full year;
- Issuers must consider any contractual transfer restrictions beyond those imposed by law;
- Physical securities must include appropriate legends;
- Under Rule 144, issuers must develop appropriate exceptions to transfer allowances to cover “affiliates” (basically officers, directors and other controlling persons) who are subject to more restrictive obligations;
- In conjunction with third-party transfer agents, issuers must develop protocol for handling transfer requests; and
- As time elapses, issuers and purchasers should address the extent, if any, to which legal restrictions lapse, removing legends from physical certificates and allowing transfers if contractual restrictions are satisfied.

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