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Restricted Securities vs. Control Securities: What Are the Differences?

Sales of restricted securities and control securities are both regulated by Rule 144. However, there are important differences in how they are treated.

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Rule 144 under the Securities Act of 1933 (Securities Act) permits public resales of "restricted securities" without registration under Section 5 of the Securities Act. A person selling restricted securities who satisfies all applicable conditions of Rule 144 is deemed not to be engaged in a distribution and therefore not an "underwriter," as defined in Section 2(a)(11) of the Securities Act, with respect to that transaction. The seller therefore may rely on the Section 4(a)(1) exemption (for transactions by persons other than issuers, underwriters or dealers) for that resale. In addition, as discussed below, Rule 144 also regulates public sales of "control securities," which are any securities that are being sold by (or on behalf of) an affiliate of the issuer. There are important distinctions in the treatment of restricted securities and control securities under Rule 144, and the manner in which they can be sold.

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What Are Restricted Securities?

Restricted securities include, among others:

- securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering;
- securities acquired from the issuer that are subject to the resale limitations of Rule 502(d) of Regulation D or Rule 701(c) (securities issued under certain exempt employee benefit plans);
- securities acquired in a transaction or chain of transactions meeting the requirements of Rule 144A; and
- equity securities of domestic issuers acquired from the issuer, a distributor, or any of their respective affiliates in a transaction subject to the conditions of Rule 901 or Rule 903 of Regulation S.

Because these types of securities were not issued in registered offerings, the federal securities laws restrict their public distribution.

What Are Control Securities?

Rule 144 also governs the resale of securities owned by an affiliate of the issuer of the securities. These are referred to as "control securities,"

although that term is not used in Rule 144.[1] This is due to the operation of Rule 144(b)(2):

> Any affiliate of the issuer, or any person who was an affiliate at any time during the 90 days immediately before the sale, who sells restricted securities, or any person who sells restricted ***or any other securities for the account of an affiliate of the issuer of such securities***, or any person who sells restricted or any other securities for the account of a person who ***was an affiliate at any time during the 90 days immediately before the sale***, shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the [Securities] Act if all of the conditions of this section are met. (Emphasis added.)

Control securities appear in a number of situations, some of which are not easily recognizable. Examples of control securities, the resale of which would either require compliance with Rule 144 or registration under the Securities Act, include:

1. Securities issued in an offering registered on Form S-8 to an affiliate of the issuer under an employee benefit plan;

2. Registered securities acquired by an affiliated dealer of the issuer (typically in a market-making transaction); and

3. Any other securities acquired by an affiliate of the issuer, including restricted securities.

Because these securities are owned by an affiliate of the issuer, the federal securities laws restrict the extent of their public distribution unless there is an effective registration statement for their resale. When considering the operation of Rule 144, it is important to note that securities held by an affiliate may be both restricted securities and control securities.

Operation of Rule 144

Any person who is selling restricted or control securities must comply with Rule 144 to be certain of the exemption from registration provided by Section 4(a)(1) of the Securities Act. A key difference in the treatment of restricted and control securities under Rule 144 is the requirement of a holding period, which is applicable only to restricted securities under Rule 144(d). A six-month holding period is required for restricted securities of an issuer that has been a reporting company under the Securities Exchange Act of 1934 (Exchange Act) for at least 90 days and is current in those reporting obligations at the time of sale. A one-year holding period is required for restricted securities of a non-reporting company or a reporting company that is not current in its reporting obligations at the time of sale. Resales of control securities are subject to additional obligations under Rule 144. Accordingly, the operation of Rule 144 can be separated into four distinct situations:

1. If a non-affiliate holds securities that are not restricted securities, there are no limitations on that person's resales;

2. If a non-affiliate holds restricted securities, the non-affiliate must satisfy the holding period requirement and then there are no limitations on that person's resales;

3. If an affiliate holds securities—which would be "control securities"—that are not restricted securities, that person would not be subject to the holding period, but would be required to sell in accordance with the non-holding period requirements of Rule 144, including volume limitations, continued issuer satisfaction of Exchange Act reporting obligations, manner of sale requirements, and filing requirements; and

4. If an affiliate holds securities—which would be "control securities"—that are restricted securities, that person would be required to satisfy

the holding period applicable to restricted securities and then comply with the other requirements of Rule 144, including volume limitations, continued issuer satisfaction of Exchange Act reporting obligations, manner of sale requirements, and filing requirements.

The Securities and Exchange Commission (SEC), takes the view that transactions, not securities, are registered. As a result, securities that previously were issued in registered offerings can become control securities in each of the situations described above, requiring an exemption—such as Rule 144—for, or registration of, their public resale.

The affiliate's intended method of disposing of control securities may be determinative as to whether the resale will require registration or if Rule 144 will be available. The "manner of sale" requirement required by Rule 144(f) is interpreted by the SEC to require the use of a non-affiliated dealer.[2] The dealer reselling restricted or control securities cannot solicit or arrange for the solicitation of orders to buy securities in anticipation or in connection with the transaction.[3] Consequently, an affiliate owning control securities could not pre-arrange a buyer for their sale under Rule 144.

Because Rule 144 is a safe harbor under Section 4(a)(1) of the Securities Act, which is not available to issuers, Rule 144 is not available for an issuer selling its own securities.[4] Nor is the rule available for a sale of the issuer's securities by its subsidiary, because a parent-issuer may not do indirectly through a subsidiary what it may not do directly under Rule 144.[5] As a result, resales under Rule 144, including resales of debt securities, could not be made by a dealer that is an affiliate of the issuer; those resales must be made through a non-affiliated dealer.

Registered Resales

The Securities Act requirements regarding resale of any control security can be resolved by registration of the resale of the control securities with the SEC if Rule 144 is too restrictive (for example, if the affiliate wishes to sell equity securities to a known purchaser or any securities in amounts that exceed the rule's volume limitations) and the issuer is amenable to filing on the appropriate form. For example, General Instruction C to Form S-8 allows for a resale prospectus to register the resale of control securities issued under an employee benefit plan and held by an affiliate. This combination registration statement is sometimes referred to as a Form S-3/S-8 (or F-3/S-8).

Issuers with affiliated broker-dealers (typically, financial holding companies) will note the registration of the resale by the broker-dealer of the issuer's securities in market-making transactions by means of a footnote under the "Calculation of Registration Fee" table in the issuer's Form S-3 or F-3.[6] No fee is required for that registration under Rule 457(q). The prospectus, while primarily drafted with the initial issuance of the securities in mind, will state that it also may be used in market-making transactions by the affiliated broker-dealer. As noted above, an affiliated market-maker would not be able to use Rule 144 to resell its parent-issuer's securities.

An affiliate of an issuer that acquires the issuer's registered securities in the open market, such as after an initial public offering, or as a gift, would need to have the issuer register the resale of those securities on Form S-3 or F-3 by means of a selling security holder prospectus, if the affiliate does not want to avail itself of Rule 144.

What Does the Transferee Receive?

In a resale that is registered, the transferee does not receive restricted securities. If the transferee is an affiliate, however, that transferee would receive control securities due to its status as an affiliate.

The resale status of securities sold in an unregistered transaction will depend on the nature of

the sale of those securities and the nature of the transferee, as follows:

- If the transferee of a restricted security or a control security is not an affiliate and the transaction is not made in accordance with Rule 144, it will own a restricted security and the holding period will start over from the date of the transferee's acquisition of the security[7] (subject to specific provisions in Rule 144 that may alter the calculation of the holding period);[8]

- If the transferee of a restricted security or a control security is an affiliate and the transaction is not made in accordance with Rule 144, it will own a control security that is also a restricted security, with the required holding period starting over from the date of the transferee's acquisition of the security[9] (subject to specific provisions in Rule 144 that may alter the calculation of the holding period);

- If the transferee of a restricted security or a control security is not an affiliate and the transaction is made in accordance with Rule 144, it will own a freely transferable, unrestricted security;[10] and

- If the transferee of a restricted security or a control security is an affiliate and the transfer is made in accordance with all of the conditions of Rule 144, the affiliate will own a security that is a control security but not a restricted security.[11]

Other Alternatives: Rule 144A and Section 4(a)(1)(½) Private Resales

A seller may want to avail itself of one of the private resale exemptions if, for example, it wants to resell prior to the completion of the Rule 144(d) holding period for restricted securities. The two private exemptions for resale are Rule 144A and the "Section 4(a)(1½)" exemption. In contrast to public resales of restricted or control securities in compliance with all of the conditions of Rule 144, transferees in private resales will receive either restricted securities or securities that are not immediately freely transferrable.

Rule 144A

Restricted securities may be resold to qualified institutional buyers (QIBs) under Rule 144A, provided that the seller satisfies the other requirements of the rule. The Rule 144A safe harbor enables persons other than the issuer to resell, in a transaction not involving a public offering, restricted securities acquired from the issuer.

Transactions in compliance with Rule 144A are not "distributions," even though the purchaser of the securities from the issuer may purchase those securities with a view to reselling them. Any person who sells securities under Rule 144A is not an "underwriter" within the meaning of Sections 2(a)(11) or 4(a)(1) of the Securities Act. Consequently, persons other than issuers or dealers selling securities in reliance on Rule 144A may rely on the exemption from registration provided by Section 4(a)(1) of the Securities Act and dealers may rely on the exemption from registration provided by Section 4(a)(3) of the Securities Act.[12] Because securities sold by dealers in compliance with Rule 144A have not been "offered to the public" within the meaning of Section 4(a)(3)(A) of the Securities Act,[13] the exemption from registration provided by Section 4(a)(2) of the Securities Act is available to the issuer.

There are four conditions to reliance on Rule 144A:

1. The resale is made only to a QIB or to a purchaser that the re-seller (and any person acting on its behalf) reasonably believes is a QIB;

2. The re-seller (or any person acting on its behalf) must take reasonable steps to ensure that the buyer is aware that the re-seller may

rely on Rule 144A in connection with the resale;

3. The securities resold: (a) when issued were not of the same class as securities listed on a U.S. national securities exchange or quoted on a U.S. automated inter-dealer quotation system; and (b) are not securities of an open-end investment company, unit investment trust, or face-amount certificate company that is, or is required to be, registered under the Investment Company Act of 1940; and

4. Where the securities are issued by an issuer that is neither a company subject to the reporting requirements of the Exchange Act, or a foreign issuer exempt from reporting under Rule 12g3-2(b) of the Exchange Act, or a foreign government, the holder and a prospective buyer designated by the holder must have the right to obtain from the issuer and must receive, upon request, certain reasonably current information about the issuer.

General solicitation is now permitted in connection with resales under Rule 144A, but sales may be made only to QIBs.[14] Unlike Rule 144, Rule 144A is available to an affiliate of the issuer selling control securities, even though Rule 144A, by its terms, is not available to the issuer of the securities.[15]

The purchaser of a security transferred under Rule 144A will receive a restricted security.[16] Consequently, it is unlikely that an owner of control securities would use Rule 144A to sell its securities to a QIB. The transferred securities would be subject to the Rule 144 holding period, causing the transferee to acquire a security subject to transfer restrictions that are not applicable to the control security in the hands of the transferor.

Section 4(a)(1½)

The Section 4(a)(1½) exemption also is available for resales of restricted securities. This exemption is a case law-derived exemption that allows the resale of privately placed securities in a subsequent private placement. This exemption permits sellers of securities to rely on Section 4(a)(1) (which provides an exemption for persons other than issuers, underwriters and dealers) to avoid underwriter status by implementing the same kinds of restrictions that would be required in the case of a Section 4(a)(2) offering by the issuer itself.[17]

Under Section 2(a)(11) of the Securities Act, 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 participation in the direct or indirect underwriting of any such undertaking" is an underwriter. Individual investors also may be "underwriters" within the meaning of Section 2(a)(11) if they "act as links in a chain of transactions through which securities move from an issuer to the public."[18] The second sentence of Section 2(a)(11) specifically includes, in the term "issuer" as it is used in the definition of "underwriter," control persons (affiliates of the issuer).

Once outside of the safe harbors of Rule 144 and Rule 144A, the seller claiming the Section 4(a)(1½) exemption must ensure that the sale is not part of an unregistered public distribution; accordingly, the seller must not be an underwriter and cannot be considered an underwriter due to the future actions of the purchaser. The purchaser must not take the securities "with a view to distribution" at the time of its acquisition.[19]

To back up that analysis, sellers of restricted securities under the Section 4(a)(1½) exemption should take the following actions, much the same as an issuer would do in a Section 4(a)(2) offering to ensure a good private placement:

- legend the securities to indicate that they cannot be resold without an exemption; the legend on restricted securities sold by an affiliate should indicate that the securities are

"restricted securities" within the meaning of Rule 144(a)(iii);

- obtain written representations from the purchaser that it is purchasing the security for investment, and not for distribution, and that it understands the restrictions on transfer applicable to the securities; and

- have the issuer contact the transfer agent to code the securities so that they cannot be transferred without the transferor obtaining an opinion of counsel satisfactory to the issuer.[20]

One prerequisite for a Section 4(a)(2) offering is the ability of the purchaser to obtain information about the issuer in making its investment decision. Rule 506 and Rule 144A both have information requirements for investors. There are information requirements in a Rule 506 offering, if the investor is not an accredited investor,[21] and also in a Rule 144A offering if the issuer is not subject to the reporting requirements of the Exchange Act, if it can avail itself of the exemption from reporting under the Exchange Act provided by Rule 12g3-2(b) thereunder or if it is a foreign government eligible to register securities under Schedule B.[22] An affiliate reselling securities may not have the ability or the necessary control to compel the issuer to provide that access. Consequently, Section 4(a)(1½) resales of securities of issuers that are subject to the reporting requirements of the Exchange Act or that are foreign private issuers in compliance with their home country reporting requirements fit more easily within the exemption than resales of securities of non-reporting issuers. In the latter case, the best practice would be if the seller could provide to the purchaser the type of information required by Rule 502(b) for sales to non-accredited investors or the type of information that would be required by the registration form that the issuer would use in a registered offering of the same securities.

Affiliates selling control securities in a Section 4(a)(1½) exemption should use the same procedures as discussed above. For these resales, however, there is no concern about the resale by the seller being viewed as one of the links in a chain of transactions leading back to an unregistered distribution by the issuer, because the original sale of the securities was registered. Nonetheless, affiliates selling control securities usually follow the restrictions enumerated above, including access to issuer information.

The purchaser must not take the securities "with a view to distribution" at the time of its acquisition.

The Section 4(a)(1½) exemption typically is relied on in connection with the resale of restricted securities to accredited investors who make appropriate representations as to their investor suitability (their status as QIBs or accredited investors) and their investment intent (that they are acquiring the securities for investment purposes rather than with a view to distribution). Generally, if an institutional accredited investor cannot qualify as a QIB under Rule 144A, the seller will seek to use the Section 4(a)(1½) exemption for secondary sales of privately-held securities. We believe that general solicitation should not be permitted when relying on the Section 4(a)(1½) exemption due to its basis in Section 4(a)(2).[23]

The unaffiliated purchaser of a restricted security in one of the private resale methods described above may be able to "tack" its holding period on to the previous owner's holding period in compliance with Rule 144(d) until the holding period requirement has been met. Once the Rule 144(d) holding period requirement and all other applicable conditions of Rule 144 have been met, the unaffiliated purchaser will own a freely transferrable, unrestricted security.

Hedging

Holders of restricted or control securities may wish to hedge their exposure to the securities through a transaction with a broker-dealer instead of engaging in a resale. The SEC provided guidance on hedging transactions in respect of restricted or control securities in an interpretive letter on December 1, 2011, to Bank of America, N.A. and Merrill Lynch, Pierce, Fenner & Smith Inc.[24] This letter builds on the guidance given by the SEC in two earlier letters to Goldman, Sachs & Co. in 1999 and 2003. The 1999 letter[25] addresses prepaid forward transactions hedged initially on an unregistered basis in accordance with Rule 144, and the 2003 letter[26] addresses forward and option-based transactions hedged initially on a registered basis. The 2011 letter expands the scope of the 1999 letter to cover all forward and option-based contracts covered by the 2003 letter.

According to the 2011 letter, restricted or control securities pledged to a broker-dealer in connection with a forward or option transaction may be treated as securities that are not restricted or control securities when used by the broker-dealer in transactions for its own account. The securities returned to the counterparty on settlement of the contract will not be restricted securities. At the time the parties enter into the forward or options contract, the holder must be able to sell outright in reliance on Rule 144 the restricted or control securities in an amount equal to the maximum number of shares deliverable on settlement, and the holder must file a notice on Form 144 with the SEC. The broker-dealer must then introduce into the public market a quantity of securities of the same class equal to the maximum number of shares deliverable on settlement of the contract in transactions compliant with Rule 144.

Conclusion

Absent registration of the resale, the best practice for affiliates selling restricted or control securities is to use the safe harbor provided by Rule 144. Section 4(a)(1½), is also available, but it requires a careful analysis of whether there is a good private placement of the securities with the purchaser. Sellers who are in doubt that a Section 4(a)(1½) resale would qualify as a good private placement should stay within one of the established safe harbors, including Rule 144A.

Notes

1. "Control securities" are securities of the issuer owned by an affiliate of the issuer. Release 33-7391 at n.5 (February 20, 1997). *See also* General Instruction C.1.(a) of Form S-8.
2. Rule 144(f)(3)(ii) exempts resales of debt securities (as defined in Rule 144(a)(4)) from the manner of sale requirement.
3. Rule 144(f)(2)(i).
4. SEC Compliance and Disclosure Interpretations (C&DI) 128.01 (January 26, 2009).
5. C&DI 528.01 (January 26, 2009).
6. The SEC does not view the exemption provided by Section 4(a)(3) of the Securities Act to be available for resales by a dealer of the securities of an affiliated issuer. The SEC's view is that this type of dealer is not within the definition of "dealer" in Section 2(a)(12) of the Securities Act, because it is not selling the securities of "another person." The SEC does not view an issuer as "another person" with respect to its affiliates. Consequently, registration of a market-making resale, and prospectus delivery, is required. *See generally* SEC Release 33-7606A (November 13, 1998) at nn.132-138 and accompanying text.
7. Purchase agreements in unregistered offerings, such as a Rule 144A purchase agreement, will frequently contain an issuer covenant that neither the issuer nor any of its affiliates will repurchase the subject securities and, if they do repurchase them, that they will cancel them. This is because an issuer's, or an affiliate's, repurchase of a restricted security restarts the clock for the holding period, which may be difficult to determine for a transferee of that security.
8. *See* the discussion below for a discussion of resales in reliance on Rule 144A and "Section 4(a)(1½) and the resale status of securities sold under those exemptions.
9. *See* footnote 7.
10. Note that Rule 144(b)(2) also captures sales of control securities by former affiliates for 90 days after the end of their affiliate status.
11. Most issuers, their transfer agents or trustees and the purchaser's broker will require an opinion of counsel to remove the restricted legend from a security that has been transferred under Rule 144.
12. *See* Rule 144A(b), (c) and Preliminary Note.

13. *See* Rule 144A(c).

14. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, SEC Rel. Nos. 33-9415, 34-69959, available at *http://www.sec.gov/rules/final/2013/33-9415.pdf* (the General Solicitation Adopting Release).

15. Rule 144A(b). *See also* C&DI 138.01 (January 26, 2009):

> **Question**: May affiliates of an issuer make resales of the issuer's eligible securities under Rule 144A?
>
> **Answer**: Yes. Affiliates of the issuer may make resales of eligible securities under Rule 144A. The rule is available to any person other than the issuer. "Issuer," as used in Rule 144A(b), has only the meaning given by Securities Act Section 2(a)(4). (The "control" clause of Securities Act Section 2(a)(11) equates the issuer and its affiliates solely for the purpose of identifying intermediaries to the public market who are underwriters within the statute's meaning. By definition, sales effected under Rule 144A are not made to the public market.)

16. Rule 144(a)(3)(iii).

17. The SEC recognizes the Section 4(a)(1½) exemption. "The Section 4(a)(1½) exemption is a 'hybrid exemption' not specifically provided for in the Securities Act that basically allows 'affiliates to make private sales of securities held by them so long as some of the established criteria for sales under both Section 4(1) and Section 4(2) of the [Securities] Act are satisfied.'" *In re Carley*, Securities Act Release No. 8888 (Jan. 31, 2008) at 14 and n.37.

18. Rule 144, Preliminary Note 2.

19. The length of time that the seller has owned the securities will be one factor to consider in determining whether a distribution has occurred. The longer the time that the seller holds the securities, the stronger is the argument that there was investment intent and that the seller is not an underwriter. If the seller is not an underwriter and the purchaser does not take the securities with a view to a distribution, then the issuer was also not involved in a public distribution, and the issuer's Section 4(a)(2) exemption is not tainted. Rule 144 addresses this issue by imposing a holding period requirement for restricted securities that is not applicable to control securities, which may have been issued in a registered transaction.

20. This step may be feasible in cases such as shares of common stock that are represented by a physical stock certificate, but it typically not feasible in cases such as debt securities that are represented by a single global note.

21. Rule 502(b)(1), (2) under the Securities Act.

22. Rule 144A(d)(4).

23. *See* C&DI 260.13 (Nov. 13, 2013) ("The use of general solicitation continues to be incompatible with a claim of exemption under Section 4(a)(2)").

24. Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Inc., SEC No-Action Letter, available at *http://sec.gov/divisions/corpfin/cf-noaction/2011/boaml120111-5.htm.*

25. *See* Goldman, Sachs & Co., SEC No-Action Letter (avail. Dec. 20, 1999).

26. *See* Goldman, Sachs & Co., SEC No-Action Letter (avail. Oct. 9, 2003).