Legal Opinions on Section 4(1½) Resale Transactions

By the Securities Law Opinions Subcommittee, Federal Regulation of Securities Committee, ABA Business Law Section

I. Introduction

This report addresses legal opinions regarding the resale of securities conducted in reliance on the so-called "Section 4(1½)"[1] exemption from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act"). The Section 4(1½) exemption, which does not appear in the Securities Act, has been developed by applying some of the elements of Section 4(a)(2) of the Securities Act to the exemption provided by Section 4(a)(1) of the Securities Act.

Section 5 of the Securities Act requires offers and sales of securities to be registered with the Securities and Exchange Commission ("SEC") unless an exemption from registration is available. Section 4(a)(2) exempts from registration offers and sales of securities by issuers in transactions "not involving a public offering" (i.e., private offerings).[2] Section 4(a)(1) exempts resales of securities "by any person other than an issuer, underwriter, or dealer."

Today, many unregistered resales are conducted pursuant to Securities Act Rule 144. Under Rule 144, a person who resells securities in compliance with its conditions is deemed not to be engaged in a "distribution" of securities and, therefore, not to be an "underwriter" for purposes of the Section 4(a)(1) exemption. Rule 144 permits resales by non-affiliates of "restricted securities"[3] that have been held for at least six months if the issuer has been subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and is current in its reports or for at least one year in all other cases.

1. Although the JOBS Act renumbered the paragraphs within Section 4 of the Securities Act, including changing Sections 4(1) and 4(2) to Sections 4(a)(1) and 4(a)(2), this report continues the convention of referring to this exemption, which operates outside the requirements of an express statutory provision or rule, as the "Section 4(1½) exemption."

2. For a discussion of the Section 4(a)(2) exemption, see Comm. on Fed. Reg. of Sec., ABA Section of Bus. Law, *Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors—A Report*, 66 Bus. Law. 85 (2010) [hereinafter ABA Private Placement Report].

3. Rule 144(a)(3)(i) defines restricted securities to include "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." 17 C.F.R. § 230.144(a)(3)(i) (2021).

Importantly, Rule 144 also permits resales of securities by affiliates, subject to compliance with holding period, volume and manner of sale limitations, and Form 144 filing requirements.[4] The availability of the Rule 144 safe harbor has significantly reduced the need for resales apart from Rule 144.

Rule 144 is not, however, the only exemption available for unregistered resales of securities. In addition to other exemptions provided in the Securities Act and SEC rules,[5] holders of restricted securities and affiliates also may rely on the Section 4(1½) exemption. Although not expressly provided in the Securities Act or an SEC rule, Section 4(1½) "'allows . . . private sales of securities . . . 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.'"[6] The challenge presented by the Section 4(1½) exemption—as reflected in this quotation—is knowing which and how many of, as well as the extent to which, these "established criteria" will need to be satisfied in any particular case.[7]

The Subcommittee has issued this report to assist lawyers in preparing Section 4(1½) opinions. This report first discusses the statutory and analytical basis for the Section 4(1½) exemption. It then discusses legal issues that commonly arise with respect to compliance with the exemption and related matters for counsel to consider in connection with the preparation of a Section 4(1½) opinion. Included in this report is an illustrative form of opinion that may be used as a starting point in drafting a Section 4(1½) opinion, as well as illustrative forms of supporting holder and purchaser certificates.

II. Statutory and Analytical Basis for Section 4(1½)

The SEC has not issued any guidelines for the use of the Section 4(1½) exemption, apart from no-action letters issued by the Division of Corporation Finance prior to the adoption of Rule 144 in 1972, and judicial opinions and administrative decisions discussing the exemption are infrequent and sometimes contradictory in their legal analysis.[8]

4. An affiliate cannot take advantage of the Section 4(a)(1) exemption apart from Rule 144 or, as discussed in this report, the Section 4(1½) exemption. *See* SEC v. Cavanagh, 445 F.3d 105, 111 (2d Cir. 2006) ("It is well-established that an 'affiliate' of the issuer—'such as an officer, director, or controlling shareholder'—'ordinarily may not rely upon the Section 4(1) exemption.'").

5. For example, Section 4(a)(7) of the Securities Act exempts from registration resales of securities to "accredited investors" as defined in Rule 501(a) of Regulation D, so long as the transaction satisfies the prohibition on general solicitation and general advertising and the information and other requirements of Section 4(a)(7). In addition, Rule 144A exempts from registration resales to qualified institutional buyers, and Regulation S exempts from registration resales to non-U.S. persons outside the United States.

6. Zacharias v. SEC, 569 F.3d 458, 465 (D.C. Cir. 2009) (referring to sales by affiliates and quoting the SEC in *In re* John A. Carley, Opinion of the Commission and Order Imposing Remedial Sanctions, Admin. Proc. File No. 3-11626, Securities Act Release No. 8888, 92 SEC Docket 1693 (Jan. 31, 2008)).

7. Holders seeking an exemption from registration outside the available express safe harbors face a "substantial burden of proof" in establishing an exemption from registration. *Cavanagh*, 445 F.3d at 114.

8. For a detailed history of judicial opinions, administrative decisions, and no-action letters underlying the development of the Section 4(1½) exemption, see Comm. on Fed. Reg. of Sec., ABA Section

By its terms, Section 4(a)(2) is available only to an "issuer," which Section 2(a)(4) of the Securities Act defines as a "person who issues or proposes to issue any security." Accordingly, while Section 4(a)(2) principles inform the analysis, the Section 4(1½) exemption is grounded in the exemption from registration provided by Section 4(a)(1).[9] As noted above, Section 4(a)(1) provides an exemption from registration for "transactions by any person other than an issuer, underwriter, or dealer." Given that a holder of securities is not an "issuer," and assuming that the holder is not a "dealer,"[10] the availability of a Section 4(a)(1) exemption turns on the question of whether the holder will be treated as an "underwriter," as defined in Section 2(a)(11) of the Securities Act.

Section 2(a)(11) defines an "underwriter" as a holder who acquires securities from an issuer (or, through the definition of "issuer" for purposes of that section, from an affiliate)[11] with a "view to . . . distribution" or who sells securities "for an issuer in connection with [a] distribution." To determine the existence of a distribution under Section 2(a)(11), courts and commentators have long turned to Section 4(a)(2) jurisprudence, which treats a distribution as substantially equivalent to a public offering.[12] As a result, the analysis of whether a holder is an underwriter for purposes of the Section 4(a)(1) exemption "necessarily entails an inquiry into whether the transaction involves a public offering."[13]

If a holder of restricted securities or an affiliate cannot resell its securities pursuant to another exemption from registration and its resale is not registered, then its resale must take on certain elements of a private offering under Section 4(a)(2). This is because, if the applicable elements of Section 4(a)(2) are satisfied, then the resale will not constitute a public offering and this, in turn, will mean that the resale will not be part of a distribution and the holder will not be an "underwriter." Therefore, the resale will be eligible for the exemption provided by Section 4(a)(1) by way of Section 4(a)(2)—in other words, Section 4(1½).

of Bus. Law, *The Section "4(1½)" Phenomenon: Private Resales of Restricted Securities*, 34 Bus. Law. 1961, 1970–71 (1979) [hereinafter ABA 4(1½) Report].

9. *Id.* at 1970.

10. As defined in Section 2(a)(12) of the Securities Act, a dealer is "any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person." 15 U.S.C. § 77b (2018).

11. Section 2(a)(11) defines as an "issuer" for purposes of that section any person directly or indirectly controlling, controlled by or under common control with the issuer (i.e., an affiliate).

12. *See* 2 Louis Loss, Joel Seligman & Troy A. Paredes, Securities Regulation 1109 n.567 (2021) (to find an underwriter, the sale must involve a contemplated distribution, "a term which the Commission regards as more or less synonymous with a 'public offering' as used in section 4(2)"). *See also* Preliminary Note 2 to Rule 144 (noting that "individual investors . . . may be 'underwriters' if they act as links in a chain of transactions through which securities move from an issuer to the public"). "Distribution," as used in the Securities Act, is to be distinguished from "distribution" as used for purposes of Regulation M under the Exchange Act.

13. Ackerberg v. Johnson, 892 F.2d 1328, 1335 (8th Cir. 1989).

III. Legal Issues Arising Under Section 4(1½) and Opinion Considerations

A. Not Engaged in a "Distribution"

The critical inquiry in determining the availability of the Section 4(1½) exemption is whether the holder is engaged in a "distribution." As noted above, a distribution is effectively synonymous with a "public offering," the existence of which has been analyzed by the courts in accordance with the U.S. Supreme Court's decision in *Ralston Purina*, which focused on "the needs of the offerees for the protections afforded by registration."[14] Accordingly, a holder's resale to purchasers who can "fend for themselves"[15] without registration is a relevant factor in establishing that a transaction does *not* involve a "public offering."[16] In evaluating this factor, courts typically look to the type of information about the issuer made available to a purchaser and attributes or qualifications of a purchaser that suggest its sophistication and its ability to gain access to and evaluate information about the issuer.

The ABA Private Placement Report suggests that the following four factors be used by lawyers and the courts in determining the availability of the Section 4(a)(2) exemption[17]:

1. *Manner of offering*—how the purchasers of the particular securities offered are found —whether through a public process (e.g., general solicitation, advertising, seminars, etc.) or a non-public process.[18]

2. *Eligibility of the purchasers*—whether each purchaser (not all offerees), either alone or with a qualified adviser, has such knowledge and

14. SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1953); *see* Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959) (applying *Ralston Purina* to resales and finding the resales were part of a "public offering" and therefore a "distribution," making Section 4(a)(1) unavailable because reseller was an "underwriter").

15. *Ralston Purina Co.*, 346 U.S. at 125.

16. In *Ralston Purina*, the Supreme Court declined to rely on the number of offerees or purchasers in an offering to determine the existence of a "public offering," instead focusing on the statutory purposes of the Securities Act and specifically noting that "there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation." *Id. Ralston Purina* emphasized that an exemption from registration under Section 4(a)(2) should be guided by access to information about an issuer and the sophistication of the offerees. *See also* Van Dyke v. Coburn Enters., Inc., 873 F.2d 1094, 1098 (8th Cir. 1989) (noting that registration is unnecessary where offerees have access to information provided in a registration statement); Sorrell v. SEC, 679 F.2d 1323, 1326 (9th Cir. 1982) ("The offeree's access to financial information about the investment, similar to what would be found in a registration statement, is crucial.").

17. ABA Private Placement Report, *supra* note 2, at 93.

18. The ABA Private Placement Report also notes that "neither the issuer nor any person acting on its behalf may offer or sell the securities [in a Section 4(a)(2) offering] by any form of 'general solicitation' or 'general advertising.'" *Id.* at 109. *See also* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415, 78 Fed. Reg. 44771, 44774 (July 24, 2013) (noting that "an issuer relying on Section 4(a)(2) outside of the Rule 506(c) exemption will be restricted in its ability to make public communications to solicit investors for its offering because public advertising will continue to be incompatible with a claim of exemption under Section 4(a)(2)").

experience in financial and business matters as to be capable of evaluating the merits and risks of the prospective investment.

3. *Information*—whether each purchaser (or its qualified adviser) receives, or has meaningful access to, such information as that purchaser needs to make an informed investment decision.

4. *Resales*—whether steps appropriate in the circumstances are taken to prevent resales that are not registered or exempt from registration.

The following subsections discuss the third and fourth factors noted above and other considerations relevant to the availability of the Section 4(1½) exemption.

B. Availability of Information[19]

Because the holder is not an issuer or in the same position as an issuer to provide information, the information requirements of Section 4(a)(2)[20] do not apply to the same extent to the Section 4(1½) exemption. The extent to which such information requirements do apply will depend on a number of factors. Some factors bearing consideration include:

- Whether the issuer of the securities is a reporting company under the Exchange Act and is current in its reporting obligations. If the issuer is not a reporting company, whether sufficient information about the issuer is nonetheless publicly available.[21]

- Whether the relationship of the holder to the issuer of the securities provides the holder with access to information about the issuer that the holder is permitted to share with the purchaser (for example, an affiliate of the issuer, such as a director or officer, may have access to information about the issuer that it is permitted to share).

- Whether the holder, even if it does not have ongoing access to information about the issuer, has received information from the issuer in connection with its purchase of the securities that is still current and that it is permitted to share with the purchaser.

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19. This section focuses on the availability of information for purposes of the Section 4(1½) exemption. Separately, Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5 prohibit the sale of securities on the basis of material, non-public information. This report does not address the potential liability under those provisions that could attach to a Section 4(1½) resale transaction.

20. *See* ABA Private Placement Report, *supra* note 2, at 111–13.

21. *See* Exchange Act Rule 15c2-11, 17 C.F.R. § 240.15c2-11 (2021).

- Whether the purchaser is a sophisticated investor and is willing to purchase the securities without receiving information about the issuer from the holder.[22]

What information needs to be provided for the Section 4(1½) exemption to be available will depend on the totality of the circumstances. In many cases, a holder will be able to rely on the Section 4(1½) exemption without having to provide the purchaser information about the issuer. A holder and, in giving a legal opinion, its counsel will usually be able to rely on a purchaser's representation as to its status as a sophisticated investor and the adequacy of the information it has received or has access to for its decision to purchase the securities.

C. Restrictions on Further Resale

Obtaining appropriate representations and imposing transfer restrictions,[23] such as restrictive legends on stock certificates,[24] will help a holder meet its burden of "establishing that [its] sales do not constitute a disguised public distribution."[25] The representations and transfer restrictions used by an issuer in a private offering relying on the Section 4(a)(2) exemption may provide a model for a holder to use in a Section 4(1½) resale.[26]

D. Initial Issuance and Prior Resales

Because "individual investors who are not professionals in the securities business also may be 'underwriters' if they act as links in a chain of transactions through which securities move from an issuer to the public"[27]—in other words, are links in a distribution—the circumstances surrounding the initial issuance of the securities by the issuer and any resales of the securities before their

22. Securities Act Rule 506 does not contain an information requirement for sales to accredited investors, which suggests that access to information should not be viewed as an absolute requirement, as opposed to an element to be considered in the total mix of considerations.

23. *See, e.g.*, Securities Act Rule 502(d), 17 C.F.R. § 230.502(d) (2021).

24. The legend typically would state that the securities (i) are restricted securities and are subject to resale restrictions, (ii) have not been registered under the Securities Act, and (iii) may not be offered or sold without registration or pursuant to an exemption from the registration requirements of the Securities Act. The legend also sometimes requires that an opinion be given that resale of the securities does not require registration.

25. SEC v. Cavanagh, 1 F. Supp. 2d 337, 368–69 (S.D.N.Y. 1998).

26. Courts and commentators have viewed favorably "precautions" taken by a holder of restricted securities to ensure that the resale of those securities would not be treated as a public offering, including "placing a legend on the securities alerting the buyer to the restricted character of the securities" or issuing a "stop-transfer order" to the transfer agent for the securities, "which would prevent the buyer from reselling without obtaining an opinion by counsel for the issuer as to the legality of the resale." *Cavanagh*, 1 F. Supp. 2d at 369. The Commission has expressed the same view with regard to Section 4(a)(2) offerings. *See* Use of Legends and Stop-Transfer Instructions as Evidence of Non-Public Offering, Release No. 33-5121, 36 Fed. Reg. 1525 (Dec. 30, 1970). *See also* Securities Act Rule 502(d), 17 C.F.R. § 230.502(d) (2021). In some cases, however, depending on the nature of the purchaser, notice alone to the purchaser of the restrictions without all of the restrictive measures may be sufficient.

27. Preliminary Note 2 to Rule 144.

acquisition by the current holder can be relevant to the availability of the Section 4(1½) exemption for resales by the current holder. Their relevance primarily turns on whether the initial issuance and any subsequent resales, taken together, can be viewed as being "connected" to each other as part of a "scheme" or "plan" to distribute the securities publicly.[28] For this reason, counsel opining on the availability of the Section 4(1½) exemption ordinarily should seek information from the client regarding the circumstances surrounding the client's acquisition of the securities.

IV. Form of Section 4(1½) Opinion and Related Certificates

A. Form of Legal Opinion

Following receipt of satisfactory confirmations as to the factual matters set forth below (as appropriate under the circumstances) and in reliance on those confirmations, counsel may deliver an opinion such as the following:

> *Based on such matters of law as we have considered appropriate and, as to matters of fact, Certificates*[29] *of Holder and Purchaser, we are of the opinion that the offer and sale of the Securities by Holder do not require registration under the Securities Act.*[30]

B. Form of Holder Certificate

Given the importance of establishing the factual "requirements" for a Section 4(1½) exemption as a basis for the opinion, counsel should seek certificates from the holder of the securities and the purchaser of the securities confirming the facts that form the basis for the opinion. Counsel may use the following language as a starting point in drafting a certificate from the holder, tailored as appropriate to the applicable facts:

Holder hereby represents as follows:

1. Holder understands that the offer and sale of the Securities to Purchaser has not been registered under the Securities Act by reason of an exemption from the Securities Act's registration requirements and that the

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28. *See* Zacharias v. SEC, 569 F.3d 458, 465–66 (D.C. Cir. 2009) (noting that "the record provides ample evidence that all of the sales were connected" and characterizing the relationship between the individual transactions as being part of a "scheme" or "plan"). *See also* SEC v. Telegram Grp. Inc. & TON Issuer, Inc., 448 F. Supp. 3d 352, 380 (S.D.N.Y. 2020) (holding that Telegram "did not intend for the Grams [the subject securities] to come to rest with the Initial Purchasers" but rather, for the "Grams to be distributed to the public through the Initial Purchasers").

29. Instead of separate certificates, counsel may rely on representations in an agreement for the resale of the securities.

30. No-registration opinions ordinarily do not identify the exemption on which they are based. Although not necessary, some counsel add the following limitation to their opinion for clarity: *This opinion is limited to the federal securities laws of the United States of America.* Counsel may also consider adding, as is typical in Rule 144A opinions: *We express no opinion as to any subsequent resale of the Securities.*

availability of that exemption depends, among other things, on the accuracy of the representations in this certificate.

2. The offer and sale of the Securities to Purchaser is not being effected for, on behalf of or in concert with the Issuer or any other person.

3. Holder has not offered or sold the Securities pursuant to any form of general solicitation or general advertising.

4. Immediately prior to making the offer of the Securities to the Purchaser and as of the date of this certificate, Holder had and has reasonable grounds to believe, and did and does believe, that Purchaser is an "accredited investor" as defined in Rule 501(a) of Regulation D under the Securities Act or a "qualified institutional buyer" as defined in Rule 144A under the Securities Act.

5. Holder has made available to Purchaser all material information about the Issuer within Holder's possession or to which it has access.

C. Form of Purchaser Certificate

Counsel may use the following language as a starting point in drafting a certificate from the purchaser, tailored as appropriate to the applicable facts.

Purchaser hereby represents as follows:

1. Purchaser understands that the offer and sale of Securities have not been registered under the Securities Act by reason of an exemption from the Securities Act's registration requirements and that the availability of that exemption depends, among other things, on the accuracy of the representations in this certificate.

2. Purchaser is an "accredited investor" as defined in Rule 501(a) of Regulation D under the Securities Act or a "qualified institutional buyer" as defined in Rule 144A under the Securities Act.

3. Purchaser understands that the Securities are "restricted securities" as that term is defined in Rule 144 under the Securities Act.

4. Purchaser has no present intention to resell the Securities, and Purchaser will not resell or otherwise transfer the Securities except pursuant to an exemption from the registration requirements of the Securities Act or in a transaction registered under the Securities Act.

5. Purchaser is able to bear the economic risk of an investment in the Securities and has sufficient financial resources to incur and sustain a loss

of a portion or all of its investment in the Securities without economic hardship.

6. Purchaser has received or has access to information about the Issuer that it considers sufficient to make an informed investment decision.