ATTORNEY WORK PRODUCT
PRIVILEGED AND CONFIDENTIAL

M E M O R A N D U M

November 8, 2011

TO: Annemarie Tierney, General Counsel
SecondMarket Holdings, Inc.

FROM: Andrew J. Brady

CC: Andrea Nicolas
Brian V. Breheny
Richard Aftanas

RE: Private Resales Under Securities Act Sections 4(1) and 4(1½)

This memorandum briefly explains and analyzes certain issues arising under the registration provisions of Securities Act of 1933, as amended ("Securities Act") in connection with the exercise by a non-affiliate former employee ("Non-Affiliate Seller") or affiliate employee (“Affiliate Seller”) of an employee stock option granted by a non-reporting company and the subsequent near-term private resale by the Non-Affiliate Seller or Affiliate Seller via the SecondMarket platform of the shares received upon exercise ("Option Shares").

As a preliminary matter, and by way of background for the analyses below, it is helpful to recall that the holding period for restricted securities acquired under an employee stock option *always* begins on the exercise of the option and full payment to the issuer of the exercise price. The date of the option's grant may never be used for this purpose, even if the exercise involves no payment of cash or other consideration to the issuer. Because the option is issued to the employee without any payment for the grant, the optionee holds no investment risk in the issuer before the exercise.[1] Accordingly, the holding period for the Option Shares acquired by the Non-Affiliate Seller and Affiliate Seller described above will not commence until the exercise of the option.

[1] Securities Act Rule C&DI 132.11.

Section 4(1) Exemption

Every offer and sale of a non-exempt security either must be registered or exempt from the registration requirements of Securities Act Section 5. This includes any transaction involving the resale of securities, whether public or private. Section 4(1), which is intended to differentiate between public distributions of securities and ordinary trading transactions, exempts transactions by "any person other than an issuer, underwriter, or dealer." For purposes of assessing the availability of the Section 4(1) exemption, determining whether a transaction involves an issuer or dealer is usually straightforward. Determining whether a transaction involves an underwriter, however, is more complicated because of the definition of "underwriter" in Securities Act Section 2(a)(11).[2] If a resale transaction involves an underwriter as defined under Section 2(a)(11) (hereinafter, a "statutory underwriter"), the exemption under Section 4(1) may not be relied upon by any party to that transaction.[3]

Underwriter Status—General Facts and Circumstances

A participant in a resale transaction may be deemed an underwriter when, considering all the facts and circumstances, the person appears to be acting as a conduit for the issuer in a distribution of the securities or to have purchased the securities from the issuer or an affiliate of the issuer with a view to distribution. The term "distribution" is not defined in the Securities Act, but refers to "the entire process in a public offering through which a block of securities is dispersed and ultimately comes to rest in the hands of the investing public."[4] The term is considered to be "synonymous with a public offering and means a distribution in which the shares flow into the trading markets in a manner such that members of the investing public might come to hold the shares."[5]

Persons selling securities acquired in certain types of transactions exempt from the registration requirements of the Securities Act, and persons who are affiliates of the issuer of the securities, will face a particularly difficult factual hurdle to demonstrate they are not underwriters in a distribution.

---

[2] Section 2(a)(11) defines the term "underwriter" as any person who:
- buys from an issuer, or its affiliates, with a view to distribution;
- offers or sells for an issuer, or its affiliates, in connection with the distribution of a security;
- participates, or has a direct or indirect participation, in such distribution; or
- participates or has a participation in the direct or indirect underwriting of such distribution.

[3] See, e.g., In the Matter of Rodney R. Schoemann, Release No. 33-9076 (Oct. 23, 2009).

[4] Jacob Wonsover, Release No. 34-41123 (March 1, 1999).

[5] In the Matter Of GFL Ultra Fund Ltd., Respondent, Release No. 33-7423 (June 18, 1997). The Supreme Court addressed the meaning of "public offering in SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

Underwriter Status—Restricted Securities

As noted above, whether a person is a statutory underwriter depends on the particular facts and circumstances.[6] When securities are sold in certain exempt transactions, those securities are deemed "restricted" securities under the Securities Act and the resale of such securities to the public in reliance on Section 4(1) raises serious concerns as to whether the seller is merely a link in a chain of transactions through which the registration requirements of the Securities Act are being circumvented. As a result of the significant risk that a resale of restricted securities may be deemed a transaction involving an underwriter, and thus will not be eligible to rely on the exemption in Section 4(1), most resales of restricted securities (or control securities) are either registered, offered and sold in compliance with Rule 144, or offered and sold in reliance on an exemption from registration other than Section 4(1), including the so-called Section 4(1½) exemption described below.

May the Non-Affiliate Seller or Affiliate Seller Rely on the Exemption Under Section 4(1) for the Proposed Resale?

No. As noted above, the Non-Affiliate Seller's and Affiliate Seller's holding period will not commence until the option is exercised. Further, we understand that in connection with the exercise of the option the Non-Affiliate Seller or Affiliate Seller (as the case may be) will enter into an agreement with SecondMarket to sell immediately the Option Shares.

Given these facts, the SEC and the courts almost certainly would take the view that the Option Shares have not come to rest in the hands of the Non-Affiliate Seller or Affiliate Seller and that absent the application of the additional conditions discussed below any resale of the Option Shares would represent a further step in a distributive process by the issuer, making the Non-Affiliate Seller or Affiliate Seller a statutory underwriter. Accordingly, the exemption under Section 4(1) would not be available to the Non-Affiliate Seller or the Affiliate Seller and his/her resale would violate Section 5. As a result of the unavailability of the exemption under Section 4(1) for the resale by the Non-Affiliate Seller or Affiliate Seller, SecondMarket would be precluded from relying on the exemptions under Securities Act Sections 4(3) or 4(4), exposing SecondMarket to strict liability under Securities Act Section 12(a)(1) for the offers and sales made in contravention of Section 5.[7]

---

[6] For a recent enforcement action that applied a facts and circumstances analysis in determining the availability of Section 4(1) to a resale transaction, see Zacharias v. SEC, 569 F.3d 458, C.A.D.C. (June 23, 2009).

[7] Section 4(3), the so-called dealer's exemption, covers principal or agency transactions by a dealer not in connection with a public offering or distribution of the issuer or by or through an underwriter. Section 4(4), the so-called broker's exemption, permits brokers to execute sell orders on behalf of their selling customer and unsolicited buy orders during those periods when the Section 4(3) exemption would be unavailable. The exemptions under Sections 4(3) and 4(4) are not available to a dealer or broker, as the case may be, who is selling unregistered securities for an underwriter. Sections 4(3) and 4(4), like Section 4(1), are self-executing and the burden of proof is on the claimant. Failure to comply will expose the dealer or broker to strict liability under Section 12(a)(1) for offers and sales in violation of Section 5. The buyer of the securities sold in the unregistered sale would have a right of rescission against the seller and the dealer or broker, as the case may be.

Section "4(1½)" Exemption

Section "4(1½)" is "a hybrid exemption not specifically provided for in the Securities Act but clearly within its intended purpose."[8] Section "4(1½)" is so named because it combines the analyses for the exemptions provided in Sections 4(1) and 4(2); however, it properly should be considered a subset of Section 4(1).[9] The principle or theory behind the exemption provides that transactions that would be exempt under Section 4(2) if undertaken by the issuer probably do not involve a "distribution" if undertaken by an affiliate of the issuer or holder of restricted securities. Accordingly, the exemption is favored by such parties when, as discussed above, they may have concerns that they would not be able to rely on Section 4(1) in connection with a resale transaction.

Certain commentators take the view that Section 4(1½) is particularly useful, as in the instant case, for a non-affiliate or affiliate seeking to resell restricted securities that have not come to rest.[10] In such case, the private resales are likely to be deemed part of the issuer's transaction. The non-affiliate or affiliate holder of restricted securities cannot rely on Section 4(2) for his/her resale because by its terms that exemption is available only to the issuer. However, these commentators take the view that when the holder of restricted securities engages in a private transaction solely to persons who would have qualified for participation in the private transaction had they been approached by the issuer, and if the holder of restricted securities can establish that the issuer's right to a private placement exemption for the other parts of the entire transaction, the holder of restricted securities may avoid being deemed a statutory underwriter.[11] Put another way, the non-affiliate or affiliate holder of restricted securities may

---

[8] Securities Act Release No. 6188 (Feb. 1, 1980) at n.178.

[9] See Ackerberg v. Johnson, 892 F.2d 1328, 1335 n.6 (8th Cir. 1989) ("While the term '4(1½) exemption' adequately expresses [the relationship between Sections 4(1) and 4(2)], it is clear that the exemption for private resales of restricted securities is § 4(1).").

[10] J. William Hicks, Exempted Transactions Under the Securities Act of 1933 § 6.14 (2009); The Section "4(1½) Phenomenon: Private Resale of "Restricted" Securities, 34 Bus. Law. 1961 (1979) (derived from the Report to the ABA Committee on Federal Regulation of Securities from the Study Group on Section 4(1½)" of the Subcommittee on the 1933 Act).

[11] *Id*. In a few cases courts have found that the conditions to the Section 4(2) private-offering exemption were not sufficiently present to make the Section "4(1½)" exemption available. See, e.g., United States v. Lindo, 18 F.3d 353, 358 (6th Cir. 1994) ("Because of the manner of sale, and because the numerous buyers of the stock sold by the banks in this case did not have access to the type of information found in registration statements . . ., the Section 4(2) and 4(1½) exemptions did not apply to the sales."); SEC v. Cavanagh, 2004 U.S. Dist. LEXIS 13372 at *75-76, 2004 WL 1594818 at *23 (S.D.N.Y. 2004) (finding that the undisputed evidence belied the defendant's claim that the purchasers "did not have the need for the information which would have been provided in a registration statement"); and See SEC v. Cavanagh, 1 F. Supp. 2d 337, 369 (S.D.N.Y. 1998)(court was not persuaded by the defendant's claim that Section "4(1½)" was available because the party that had purchased securities from the defendant had resold the securities soon after the purchase, and the defendant had failed "to demonstrate that it took adequate precautions to ensure that such a resale would not occur," such as placing a restrictive legend on the securities and issuing a "stop-transfer order" to the transfer agent for the securities.)

rely on the exemption provided by Section 4(1), if the original sales by the issuer, together with all subsequent resales of securities acquired in that offering, generally reflect the principles applicable to issuer offerings under Section 4(2).[12]

Because the concept of subsequent resales is not limited to the resale by the non-affiliate or affiliate but includes the buyer of his/her shares and potentially subsequent buyers, many commentators, including most prominently Professor J. William Hicks, recommend that sellers planning to rely on the exemption take the following steps to avoid the private transactions being transformed to a distribution:

- Arrange for the issuer to have a legend placed on the securities alerting the buyer that the securities are restricted as understood by Rule 144(a)(3);
- Arrange to have the issuer issue a "stop transfer order" to the transfer agent for securities to prevent the buyer from reselling the securities purchased in the Section 4(1½) transaction without obtaining an opinion of counsel as to the legality of the resale;
- Inquire into the identity of the buyer to ensure the person has the requisite sophistication and financial wherewithal to hold the securities as an investment and not immediately resell; and
- Secure a written representation by the buyer that clearly indicates the buyer's awareness of the restrictive character of the securities being purchased and the need for the buyer to hold them for investment.[13]

Would the Exemption Under Section 4(1½) for the Proposed Resale of the Option Shares by the Non-Affiliate Seller or Affiliate Seller be Adversely Impacted by the Limited Holding Period?

It is difficult to predict because the SEC has never provided any substantive guidance or instructions, the courts have not consistently addressed the issue, and academic and practitioner commentary in this area is thin. However, a defensible argument exists that the exemption under Section 4(1½) for the resale of the Option Shares by the Non-Affiliate Seller or Affiliate Seller should not be adversely impacted by the relatively short or non-existent holding period of the Option Shares by the Non-Affiliate Seller or Affiliate Seller. Under this argument, so long as the resale transaction heeds the guidance above, the Non-Affiliate Seller or Affiliate Seller (as the

---

[12] While an issuer, whether reporting or non-reporting, is not required to furnish any particular information to purchasers who are accredited investors in connection with an offering under Regulation D, the SEC has never addressed whether an accredited investor purchasing in a private resale under Section 4(1½), particularly in the case of a purchase of securities of a non-reporting issuer, must be furnished or given access to issuer information.

[13] See J. William Hicks, Exempted Transactions Under the Securities Act of 1933 § 6.12 (2009). See also, SEC v. Cavanagh, at 371-72, where the court endorsed the use of similar provisions in connection with an exemption under Section 4(1½). These provisions appear to have their bases in the previous Securities Act Rule 146 (a predecessor to Regulation D), where an issuer was required to exercise reasonable care to ensure that purchasers of the subject securities were not statutory underwriters. See Rule 502(d); Use of Legends and Stop-Transfer Instructions as Evidence of Non-Public Offering, Release No. 33-5121 (Dec. 30, 1970).

case may be) may be viewed to purchase the Options Shares not "with a view to distribution," but rather with a view to a private resale, which should not cause the Non-Affiliate Seller or Affiliate Seller or SecondMarket to be deemed a statutory underwriter.[14]

[14] This memorandum does not address the general solicitation and advertising issues discussed via telephone with SecondMarket on Thursday, January 6, 2011. As noted on the call, because the exemption under Section 4(1½) imports from Section 4(2), among other things, the prohibition on general solicitation and advertising, the SecondMarket website and related marketing materials must refrain from any communications that would threaten the private character of the transaction(s).