

# The Road to Exit and Liquidity: Understanding Registration Rights

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Properly structured registration rights provide an agreed framework between shareholder and issuer pursuant to which public dispositions of previously unregistered securities may be effectively and timely executed. Negotiation dynamics regarding key registration rights provisions are informed by a shareholder's desire to benefit from the rights necessary to effectuate numerous (and potentially rapid) monetization transactions on the one hand and the issuer's desire for orderly public dispositions of securities that minimize interference with its regular-way business and capital-raising activities on the other.

This In Depth provides a brief introduction to registration rights from the perspective of a significant investor, such as a private equity firm, and focuses on certain concepts that warrant attention when negotiating these rights.

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## What Are Registration Rights?

Registration rights are contractual rights that obligate an issuer to facilitate the public resale of previously unregistered securities through one or more transactions registered with the Securities and Exchange Commission under the Securities Act of 1933, as amended (the "Securities Act"). Registration rights are typically granted at the time of an investment in unregistered equity securities and are typically memorialized in a dedicated registration rights agreement or another transaction document, such as a stockholder's agreement.

There are generally two types of registration rights: "demand" rights, which permit an investor to require an issuer to effectuate the registration of the investor's securities on an appropriate registration statement form under the Securities Act, and "piggy-back" rights, which permit an investor to require an issuer to include the investor's securities in a registration statement under which securities are registered for sale by the issuer or another investor. Demand rights may specifically permit an investor to require an issuer, to the extent that it is not already public, to effectuate an IPO or other public

listing of its securities in order to facilitate the exercise of its registration rights in conjunction with and/or following the IPO.

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## Why Do Investors Require Registration Rights?

Under the U.S. federal securities laws, a security may be offered and sold only pursuant to a registration statement filed with the SEC under the Securities Act or pursuant to an applicable exemption from registration. Securities sold in transactions registered under the Securities Act may be freely sold into the public capital markets (i.e., to both institutional and retail investors) unconstrained by statutory or rule-based limitations.

In the absence of Securities Act registration, the most commonly utilized exemption for the resale of securities by investors is Section 4(a)(1) of the Securities Act, which provides an exemption for transactions by any person other than an issuer, underwriter or dealer. To ensure the availability of the Section 4(a)(1) exemption, an investor selling “restricted” securities (i.e., securities acquired in unregistered transactions) or “control” securities (i.e., securities held by an “affiliate” of the issuer) must comply with the relevant provisions of Rule 144 of the Securities Act. While useful, Rule 144 precludes the sale of restricted securities during a holding period of six or 12 months (depending upon whether the issuer of the securities has been an SEC reporting company for at least 90 days immediately before the sale of the securities) and subjects the sale of control securities to volume and manner of sale limitations.

Other exemptions may be relied upon to sell restricted or control securities; however, such exemptions generally limit the pool of potential investors to institutional investors and certain sophisticated investors, and purchasers often demand a “liquidity discount” on the purchase price because the securities will be “restricted” in the hands of the purchaser.

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## Is the Security a “Registrable Security”?

A threshold question is whether the security held by an investor falls within the scope of the stipulated registration rights. Most commonly, a defined term such as “registrable security” will circumscribe the securities to which registration rights apply and the circumstances under which previously registrable securities cease to be registrable. An investor will want to ensure that registrable securities remain so at least until the investor is able to resell the securities under Rule 144 without limitation (e.g., until any applicable holding period has fallen away and, if the investor is an affiliate, until the securities it holds cease to be control securities).

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## General Limitations: Size, Frequency and Scope

An investor's natural inclination is to negotiate for broad registration rights that allow for unlimited or frequent registrations of any number of securities. From the issuer's perspective, it is often appropriate (and reasonable) to limit the number or frequency of registrations (and/or "take-downs" under a shelf-registration statement) during a given period (or in the aggregate) and to require a minimum number of securities for which registration rights may be exercised. If the number of demands is unlimited, there are generally other typical limitations (such as an aggregate offering price) that are designed to mitigate management distraction—particularly with respect to participation in roadshows and other marketing activities—and to manage the issuer's allocation of resources.

Such limitations, however, can significantly restrict an investor's ability to effectively and timely monetize its investment. Accordingly, an investor should consider whether the proposed restrictions unreasonably impair its ability to achieve investment objectives and are appropriately tailored relative to the number and value of the securities it holds. An investor should also review whether registration rights fall away after a date certain or following the occurrence of certain events (e.g., the registrable securities outstanding fall below a certain number or fair market value threshold) and whether the fall-away trigger aligns with its investment horizon.

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## Suspension Periods: How Often and for What?

Registration rights customarily provide an issuer with the right to suspend or postpone a registration or shelf takedown request in certain circumstances, most commonly when the effectuation of such request would require the issuer to publicly disclose material nonpublic information that the issuer would not otherwise be ready or required to disclose or if disclosure would have a material adverse effect on an acquisition, disposition, financing, reorganization or other significant transaction. An issuer's ability to suspend or postpone use of a registration statement is typically limited by frequency and duration limitations on the suspension period. When negotiating suspension periods, an investor should consider:

- limiting suspension periods in the aggregate by imposing a maximum number of days per suspension period and a cap on the total number of days within a specific period (e.g., no more than 60 days at one time and no more than 90 days in the aggregate in any 12-month period);

- whether the circumstances under which the issuer may postpone a registration are appropriately delineated;
- whether management or the board of directors determines that a postponement is warranted (and, in either case, whether a certification attesting to the necessity of the suspension is required); and
- making certain that a suspension period terminates after the earlier of the end of a predetermined time period and the date the circumstances triggering the suspension period have ceased.

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## Priority Cutbacks: Whose Securities Come First?

Registration rights typically contain a mechanism intended to address circumstances in marketed offerings when market demand is not sufficient to absorb all securities being offered or when the market clearing price is suboptimal, thereby requiring some number of shares to be eliminated from an offering.

The mechanism, by which shares are “cutback” according to a stipulated priority, is typically initiated at the direction of the underwriter for the offering, with the type of offering and identity of the party initiating the registration or offering usually dictating the level of priority into which an investor’s shares fall. If a registration statement is filed by the issuer for a primary offering of its shares, it would be typical for the issuer’s shares to have first priority over piggybacking investors. Similarly, in the case of a demand registration, the demanding holder would typically receive top priority. If several large investors hold relatively equivalent numbers of registrable securities, it would also be common for the securities owned by those investors to be grouped together for purposes of a cutback to avoid a “race-to-the-market” problem that can occur when the demanding holder is entitled to priority (i.e., holders may be incentivized to be the first to make a demand because they receive priority, even if it is not the ideal market for the sale).

An alternative formulation is to base the allocation on the number of shares requested to be included in the particular registration. Whether this formulation is beneficial may depend on the holders entitled to registration rights. For example, larger holders may benefit from this formulation by requesting that a large number of their registrable securities be included in the offering, knowing that they will get cutback. Smaller holders may benefit if they request that a larger percentage of their registrable securities (as compared to their percentage of the outstanding shares) are included in the registration.

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## Lock-Ups: How Long and for Which Transactions?

It is customary for registration rights agreements to require the execution of a lock-up agreement by all parties with registration rights (with a particular focus on investors with significant holdings) in the context of certain transactions involving the issuer's equity securities. These provisions will have a specific emphasis on underwritten sales of the issuer's equity securities, including sales made in connection with an IPO (even if only primary shares are to be sold) and secondary sales (even if shares are sold only by certain stockholders) to the extent requested by the relevant underwriters (which will generally be the case).

A careful review of these provisions is warranted because they may effectively preclude the sale by an investor of even a *de minimis* number of shares of the issuer's common stock for a significant period of time "away from the registration statement" (e.g., under Rule 144) and impede any ability to opportunistically sell into open-market windows. Further, the preclusive effect of a lock-up period may be exacerbated by its interaction with suspension periods (discussed above). When negotiating lock-up provisions, an investor should consider:

- whether and under what (if any) circumstances the lock-up requirement should apply to all parties with registration rights (e.g., if the issuer or another investor initiates an offering, should non-participants be required to enter into a lock-up agreement and, if so, under what circumstances);
- whether an investor may submit a demand notice during a lock-up period so they may go to market immediately following the expiration of a lock-up period;
- whether an investor can require the issuer to confidentially submit a registration statement during a lock-up period to allow for immediate market access following expiration of the lock-up period; and
- whether to stipulate an effective date for lock-up agreements, which date is proximate to the relevant offering launch date to mitigate any impact on the ability to sell some or all of the company in an M&A transaction.

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## Facilitating Block Sales

Once an issuer has achieved a certain "seasoned" status, it may no longer be necessary to conduct extensive (or any) marketing efforts in connection with an SEC-registered offering. Without a marketing process, an investor may be able to quickly sell a large

number of shares by arranging for the disposition of a block of shares through a registered “bought deal” or “block sale.” These transactions are common among investors focused on hitting short market windows (e.g., an investor could require an issuer to file an automatically effective shelf registration statement on Form S-3 and immediately thereafter execute a block sale under that shelf). In order to retain the flexibility to facilitate effective and timely execution, these provisions should be drafted with consideration given to the nature and timing of piggyback notices (if any) that a demanding investor must deliver to nondemanding holders when contemplating a block sale of securities. Investors should also consider how soon following a demand in respect of a block sale the issuer must file the registration statement and make other SEC filings necessary to effectuate the transaction.

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## Cooperation: What Is Required from the Issuer?

Registration rights agreements typically include a comprehensive list of the actions that the issuer must take to assist selling stockholders in connection with the registration, marketing and sale of their securities. Issuers generally recognize the importance of these provisions and, as a result, they are not often the subject of significant negotiation. When reviewing these provisions, an investor should consider:

- The extent to which the issuer is required to implement the investor’s comments on any registration statement and any related amendments.
- For how long the issuer must keep a registration statement and prospectus continuously effective. Except in the case of shelf registration statements, this period is typically fixed between 90 and 180 days, although some investors will require that issuers keep a registration statement effective until all of their securities have been sold.
- Whether the investor will require the issuer to use its reasonable efforts to obtain comfort letters from its independent registered public accounting firm addressed to the investor as selling stockholder. Typically, auditors will only address comfort letters to the underwriter, issuer and its Board of Directors. Under AU Section 634, however, a selling stockholder may request a comfort letter if it provides the requisite representation letter.
- Making explicit the issuer’s obligation to remove legends, deliver opinions and otherwise coordinate with the transfer agent to permit settlement of sales of shares on a timely basis.

- How registration-related expenses are allocated. Generally, issuers cover all reasonable fees and expenses incurred in complying with the registration rights provisions but may seek to limit their obligations—for example, by capping the number of roadshows they will pay for or limiting the holders of a majority of the registrable securities to a single counsel.

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Please do not hesitate to contact us with any questions.



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