

Issue Brief: Rule 144A Securities

Genti Droboniku
CDIAC Research Unit

INTRODUCTION

The current historically low interest rate environment has prompted many local agencies to look for a higher return on their investments within the constraints of California's local agency investment regulations and guidelines. In addition, the continuing decline in debt issuance by government sponsored enterprises such as FannieMae and FreddieMac, which traditionally have been a preferred investment choice, has local agencies scrambling to find allowable and safe alternative investment options. Given this backdrop, some local agencies have expressed interest in purchasing Rule 144A restricted securities.

Although Rule 144A fixed income securities may meet the requirements of Government Code 53601(k), CDIAC believes that California local agencies do not meet the Securities and Exchange Commission's (SEC) definition of an allowable buyer of these securities. The purpose of this brief is to provide a summary of Rule 144A securities and describe the rationale for CDIAC's recommendation that local agencies refrain

from holding these securities in their investment portfolio.

BACKGROUND

The Securities Act of 1933 was adopted after the market crash of 1929 with the intent "to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing."¹ Specifically, Section 5 of the Securities Act made it illegal for any person to offer and sell a security unless the transaction is registered with the Securities and Exchange Commission (SEC).²

Recognizing the limited public benefit of requiring the registration of certain private placement securities, Congress adopted Section 4(2). Section 4(2) exempts issuers of private placement securities from the requirements of Section 5 of the Securities Act.³ Although Section 4(2) allows for the issuance of private placement securities without registration, it limits the circumstances under which they can be traded.

RULE 144A DEFINITION

In 1990, the SEC approved Rule 144A of the Securities Act of 1933. The intent of Rule 144A was to facilitate "a more liquid and efficient institutional resale market for

unregistered securities."⁴ Rule 144A is based on the idea that certain institutional investors are sophisticated enough to understand the complexities and risks inherent in private placement securities. It carved out an exception from the registration requirements of the Securities Act to enable an organization to market and sell securities through an underwriter to certain institutional buyers without registering them with SEC. In addition, Rule 144A provides a "safe harbor" for these institutional buyers to trade these private placement securities with other qualified institutional buyers as defined in the rule. Further, Rule 144A requires that:

- The investor is aware that the seller is relying on Rule 144A for the sale.
- At the time of sale, the securities are not in the same class as securities listed on any national securities exchanges or quoted in an automated interdealer quote.
- The issuer is either a reporting company under the Exchange Act or makes certain information available to the security holders.⁵

In 1996, Congress enhanced the exemption under Rule 144A with the National Securities Markets Improvements Act. This legislation prohibits state securities regulators from imposing disclosure and registration requirements for certain types of securities, including Rule 144A securities.⁶

¹ Supreme Court of United States, 425 U.S. 185 (1976) *Ernst & Ernst V. Hochfelder et al*, No. 74-1042, pg. 2, paragraph 195. Retrieved on March 20, 2013 from: http://scholar.google.com/scholar_case?case=4219834259989886465&hl=en&as_sdt=2&as_vis=1&oi=scholar

² *Ibid*.

³ *The Birth of Rule 144A Equity Offerings* (2008), pg. 414, William K. Sjostrom, Jr., Professor of Law, Salmon P. Chase College of Law, Northern Kentucky University.

⁴ U.S. Federal Code of Regulations, paragraph (e). Retrieved on April 10, 2013 from www.gpo.gov/fdsys/pkg/CFR-2003-title12-vol3/xml/CFR-2003-title12-vol3-sec220-131.xml

⁵ 17 CFR 230.144A - Private resales of securities to institutions. Retrieved on April 1st, 2013 from www.law.cornell.edu/cfr/text/17/230.144A

⁶ *Understanding Rule 144A*, 2009, Lloyd S. Harmetz, Capital Markets Group of Morrison & Foerster LLP.

ELIGIBILITY

Qualified Institutional Buyers (QIBs)

The SEC allows only qualified institutional buyers (QIBs) to trade Rule 144A securities. These institutions are large sophisticated organizations with the primary responsibility of managing large investment portfolios with at least \$100 million in securities. Appendix A provides the SEC definition of QIB.

Securities and Trading

Issuers are allowed to raise both debt and equity capital through Rule 144A private placements, although the vast majority of capital is raised through debt financings. The private nature of Rule 144A securities makes it difficult to determine the size and the make-up of the market. It is estimated that between 2006 and 2010 both U.S. and foreign issuers raised more capital through 144A offerings than through initial public offerings. The SEC calculated that in 2010, using Rule 144A offerings, companies raised more than \$200 billion in capital. The same year, private placements surpassed public offerings by eight percent.⁷

One main reason for the shift from public to private offerings is the Sarbanes-Oxley Act (SOX). Responding to the collapse of several U.S. companies, Congress adopted SOX in 2002 and designated the SEC as the implementing agency. The SEC released a number of new regulations for companies seeking to issue public offerings, creating additional restrictions and increasing compliance expenses for issuers. Many of the requirements exempted Rule 144A private placements, prompting issuers to choose them over public offerings.⁸

In 1990, the National Association of Securities Dealers Automated Quotations (NAS-

DAQ) created *Private Offerings, Resales and Trading Through Automated Linkages* (PORTAL) – an industry-wide trading system designed to facilitate the exclusive secondary trading by QIBs of Rule 144A securities. PORTAL is currently the main trading platform for these securities. Its creation legitimized, expanded, and provided needed liquidity for the private placement market.

Public Entities as QIBs

Rule 144A stipulates that public agencies who invest for the benefits of their employees qualify as QIBs. Specifically, subsection 144A (a)(1)(i)(D) defines these public institutions as “*any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees*”.⁹ In California such agencies would include any pension fund that exceeds the \$100 million threshold in investments. CalSTRS and CalPERS are examples of QIBs qualifying under these terms.

PUBLIC AGENCIES CHALLENGE THE QIB QUALIFICATION REQUIREMENTS

Alaska Sovereign Wealth Fund

Some local agencies have used a 2011 SEC’s opinion that the Alaska Sovereign Wealth Fund (Alaska Fund) qualified as a QIB as an indication that other non-pension fund local agencies also qualify as QIBs. The Alaska Fund, primarily funded by oil royalties and reinvestment earnings, is managed by the Alaska Permanent Fund Corporation, a public corporation wholly-owned by the State of Alaska. Unlike other government funds, the Alaska Fund distributes a significant portion of the net income to the

state’s residents every year. In its response to Alaska Fund’s request for interpretation of whether it was a “qualified institutional buyer”, the SEC wrote: “... *the Division is of the view that the Fund, although it is not organized as an entity specifically listed in Rule 144A (a)(1)(i)(H), may be treated as a “qualified institutional buyer” as defined in that rule if it satisfies the other requirements of that definition.*”¹⁰

Although technically a public entity, the Alaska Fund differs in structure and purpose from California public agencies and should not be used as validation that non-pension fund public agencies qualify as QIBs. The Alaska Fund’s sole purpose is to invest oil royalties paid to the State. On the other hand, the primary function of a local agency is not to benefit its employees, but ideally to provide services to taxpayers.

Florida State Board of Administration

Another challenge to the SEC rule came from the Florida State Board of Administration (FA-SBA) which is responsible for administering and investing more than \$160 billion in public funds, most of which is for the state retirement system. The FA-SBA also manages the Local Government Investment Pool (LGIP), which is similar to California Local Agency Investment Fund (LAIF).

During the early and mid-2000s the FA-SBA hired a former SEC attorney to seek clarifications from the SEC as to whether the FA-SBA’s LGIP fund would qualify as a QIB, with the goal of purchasing Rule 144A securities. In its response the SEC wrote “*we read very strictly Rule 144A and what entities qualify as qualified institutional buyer*” and that local governments are not QIBs.¹¹

⁷ SEC, “Capital Raising in the U.S.: The Significance of Unregistered Offerings Using the Regulation D Exemption”, pg. 3. Retrieved on March 15, 2013 from www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf

⁸ Yu Gao, The Sarbanes-Oxley Act and the Choice of Bond Market by Foreign Firms, pg. 2. Retrieved on March 10, 2013 from: http://w4.stern.nyu.edu/emplibary/SOX_BondMkt_YuGAO.pdf

⁹ See 144A (a)(1)(i)(D) at <http://taft.law.uc.edu/CCL/33ActRIs/rule144A.html>

¹⁰ www.sec.gov/divisions/corpfin/cf-noaction/2011/alaskapermanentfund-071411-501a.htm

¹¹ “Florida State Board of Administration skirted legal advice, gambled on risky investments” *Florida Bay Times*, September 18, 2010.

The FA-SBA continued to press additional legal avenues to demonstrate their status as a QIB. Further legal opinions in 2007 concluded that the FA-SBA did not qualify as a QIB and, therefore, was not eligible to purchase 144A private placement securities. Nonetheless, using a subsection of the Investment Company Act of 1940, the FA-SBA determined that LGIP met the standard of a “qualified purchaser” and purchased \$2 billion in 144A securities. By the end of 2007, the 144A securities purchased for LGIP had lost most of their value.

In 2008, the SEC opened an investigation and requested documents related to the FA-SBA’s ability to acquire Rule 144A securities and its status as a QIB. In July of 2008, the SEC ordered a full fraud investigation on the FA-SBA and the banks that sold it Rule 144A securities. In 2010, the SEC ended the investigation of the FA-SBA with no enforcement action. However, the investigation termination letter also stated that it “*must in no way be construed as indicating*

that the party has been exonerated or that no action may ultimately result from the staff’s investigation of that particular matter.”

Local agency funds in California are more closely aligned with the FA-SBA’s LGIP than the Alaska’s Fund, but the general overall SEC consensus is that local governments do not qualify as QIBs and are not allowed to purchase Rule 144A securities. Doing otherwise, local agencies would risk not only the safety of their investments, but a possible SEC investigation.

CONCLUSION

As stated in Section 53600.5 of Government Code, the primary objective of any institution investing public funds is to safeguard principal, maintain liquidity, and then generate return. Section 27000.5 of the Government Code lists the same objectives for county treasurers and boards of supervisors. These provisions intend to safeguard public funds and promote pru-

dent investments as well as to maintain the public trust in public institutions.¹² Anytime a public agency purchases securities which are not clearly called out in statute it takes on investment, political or legal risk. Section 53601(k) of the Government Code provides that public agencies may invest in “medium-term notes, defined as all corporate and depository institution debt securities with a maximum remaining maturity of five years or less, issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States.” While Rule 144A Securities may technically meet the *organized and operating*, maturity and credit requirements of Section 53601(k), CDIAC believes that SEC rulings regarding QIBs indicate that local agencies are not eligible investors in these securities because local agencies are not QIBs. Based on this finding, CDIAC recommends against local agencies purchasing 144A securities.

¹² [California Local Agency Investment Guidelines](#), p. 9

Appendix A

QUALIFIED INSTITUTIONAL BUYERS DEFINITION – SEC OUTLINE

- a. For purposes of this section, *qualified institutional buyer* shall mean:
 1. Any of the following entities, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the entity:
 - i Any *insurance company* as defined in [section 2\(a\)\(13\)](#) of the Act ;

Note: A purchase by an insurance company for one or more of its separate accounts, as defined by [section 2\(a\)\(37\)](#) of the Investment Company Act of 1940 (the “Investment Company Act”), which are neither registered under section 8 of the Investment Company Act nor required to be so registered, shall be deemed to be a purchase for the account of such insurance company.

- A. Any *investment company* registered under the Investment Company Act or any *business development company* as defined in [section 2\(a\)\(48\)](#) of that Act;
- B. Any *Small Business Investment Company* licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958;
- C. Any *plan* established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees;
- D. Any *employee benefit plan* within the meaning of title I of the [Employee Retirement Income Security Act of 1974](#);
- E. Any trust fund whose trustee is a bank or trust company and whose participants are exclusively plans of the types identified in paragraph (a)(1)(i)(D) or (E) of this section, except trust funds that include as participants individual retirement accounts or H.R. 10 plans.
- F. Any *business development company* as defined in [section 202\(a\)\(22\)](#) of the Investment Advisers Act of 1940;

G. Any organization described in section 501(c) (3) of the Internal Revenue Code, corporation (other than a bank as defined in [section 3\(a\)\(2\)](#) of the Act or a savings and loan association or other institution referenced in section 3(a)(5)(A) of the Act or a foreign bank or savings and loan association or equivalent institution), partnership, or Massachusetts or similar business trust; and

H. Any *investment adviser* registered under the Investment Advisers Act.

- ii. Any *dealer* registered pursuant to [section 15](#) of the Exchange Act, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least \$10 million of securities of issuers that are not affiliated with the dealer, *Provided*, That securities constituting the whole or a part of an unsold allotment to or subscription by a dealer as a participant in a public offering shall not be deemed to be owned by such dealer;
- iii. Any *dealer* registered pursuant to section 15 of the Exchange Act acting in a riskless principal transaction on behalf of a qualified institutional buyer;

Note: A registered dealer may act as agent, on a non-discretionary basis, in a transaction with a qualified institutional buyer without itself having to be a qualified institutional buyer.

- iv. Any investment company registered under the Investment Company Act, acting for its own account or for the accounts of other qualified institutional buyers, that is part of a family of investment companies which own in the aggregate at least \$100 million in securities of issuers, other than issuers that are affiliated with the investment company or are part of such family of investment companies. *Family of investment companies* means any two or more investment

companies registered under the Investment Company Act, except for a unit investment trust whose assets consist solely of shares of one or more registered investment companies, that have the same investment adviser (or, in the case of unit investment trusts, the same depositor), *Provided That*, for purposes of this section:

- A. Each series of a series company (as defined in [Rule 18f-2](#) under the Investment Company Act) shall be deemed to be a separate investment company; and
- B. Investment companies shall be deemed to have the same adviser (or depositor) if their advisers (or depositors) are majority-owned subsidiaries of the same parent, or if one investment company's adviser (or depositor) is a majority-owned subsidiary of the other investment company's adviser (or depositor);
- v. Any entity, all of the equity owners of which are qualified institutional buyers, acting for its own account or the accounts of other qualified institutional buyers; and
- vi. Any *bank* as defined in section [3\(a\)\(2\)](#) of the Act, any savings and loan association or other institution as referenced in section 3(a)(5)(A) of the Act, or any foreign bank or savings and loan association or equivalent institution, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with it and that has an audited net worth of at least \$25 million as demonstrated in its latest annual financial statements, as of a date not more than 16 months preceding the date of sale under the Rule in the case of a U.S. bank or savings and loan association, and not more than 18 months preceding such date of sale for a foreign bank or savings and loan association or equivalent institution.