Rule 144A under the Securities Act of 1933, as amended (the 1933 Act), adopted in 1990, provides a non-exclusive safe harbor from registration for the resale of restricted securities to certain large institutions, defined in the rule as “qualified institutional buyers,” commonly referred to as “QIBs.” The rule was designed to permit a more liquid and efficient institutional resale market for unregistered securities and typically is associated with private placements. However, issuers also frequently rely upon the rule in connection with public offerings of securities. These offerings do not violate the securities laws because the public offering is made by a foreign issuer outside of the United States, with a concurrent limited offering to US QIBs. Often, foreign initial public offerings or new issues (IPOs) are solely made available within the United States to eligible institutions in reliance on Rule 144A for exemption from registration under the US.
federal securities laws. For example, in 2006 and 2007, the value of IPOs by foreign companies privately offered in the US Rule 144A market was approximately $111 billion, compared to approximately $18 billion in global IPOs that listed on a US exchange.¹

Investment managers investing in foreign markets need to understand Rule 144A, how it is used for IPOs as well as rights offerings outside of the US, and how to recognize (and avoid or plan for) some of the common pitfalls raised by the rule. In this article, we review the application of Rule 144A when US investment managers purchase and sell foreign (non-US) securities for US clients that are available only to US QIBs under Rule 144A. We also review some common issues faced by the international investment manager—issues that can and should be addressed in advance of an IPO to avoid last-minute scrambles or potential liability. Finally, we review the disposal of Rule 144A securities and the use of Regulation S in that context. Once the client has purchased in the foreign IPO, disposing of the securities in secondary market transactions on many foreign exchanges raises fewer issues.

**Rule 144A**

Under the US securities laws, offers and sales of securities must be registered under Section 5 of the 1933 Act, or meet an exemption from registration. Common registration exemptions appear in Section 4(1) of the 1933 Act, which exempts persons other than an issuer, underwriter, or dealer, and Section 4(2) of the 1933 Act and Regulation D under the 1933 Act, which provide a series of exemptions for transactions by an issuer not involving any public offering, known as “private placements.” In 1953, the Supreme Court, in *SEC v. Ralston Purina Co.*, established that “a transaction not involving any public offering” is “[a]n offering to those who are shown to be able to fend for themselves . . . .” Section 5 also applies to purchasers of securities who look to resell these securities in the secondary market, and thus resellers also must find an exemption.

Rule 144A is a private placement exemption for resales of securities to large institutions deemed by the Securities and Exchange Commission (SEC) to be able to “fend for themselves.” It is a “safe harbor” from registration, meaning that it is non-exclusive. As noted in the preliminary notes to the rule: “Attempted compliance with [the rule] does not act as an exclusive election; any seller hereunder may also claim the availability of any other applicable exemption from the registration requirements of the [1933] Act.” The SEC adopted Rule 144A, and resellers commonly rely on the rule, because it offers more legal certainty than reliance on the Section 4 exemptions: many cases have been litigated, and much ink has been spilled, over the criteria for determining whether a reseller is a statutory underwriter (and thus ineligible for the exemption) or is not because it had “investment intent” (rather than distribution intent) when it bought the security.

Specifically, the rule provides that any person (including a reseller), other than the issuer or a dealer, who offers or sells securities solely to QIBs in compliance with the conditions of the rule “shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter of such securities within the meaning of Sections 2(a)(11) and 4(1) of the [1933] Act.” If the safe harbor of Rule 144A is met—under objective standards designed to measure whether the rule’s conditions are indeed met—the securities do not need to be registered under the 1933 Act because the resale will be deemed exempted by 1933 Act Section 4. The rule also protects dealers who offer or sell securities to QIBs in compliance with the conditions of the rule, deeming the dealer not to be a participant in a distribution nor an underwriter of the securities, and deeming the securities not to have been “offered to the public.”

QIBs generally are specified institutions with at least $100 million in securities investments. Covered institutions include the following types of entities:¹

- Insurance companies;
- Investment companies;
- Business development companies;
- Small business investment companies;
- Public employee benefit plans;
- Employee benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA);
- Certain trust funds whose participants are exclusively plans identified above;
- Non-taxable organizations under Section 501(c)(3) of the Internal Revenue Code of 1986;
- Corporations;
- Partnerships;
- Business trusts;
- Investment advisers registered under the Investment Advisers Act of 1940;
- Certain broker-dealers;
• Banks and savings and loan associations (with at least $25 million in net worth); and
• Entities owned solely by QIBs.9

Since the SEC promulgated Rule 144A in 1990, a large institutional market has developed for 144A securities, including repurchase agreements, commercial paper, municipal securities, convertible securities and corporate bonds and notes. For example, according to available data, annual issues of 144A non-convertible debt increased from $3.39 billion in 1990 to $235.17 billion in 1998.10 Since 1990, the majority of Rule 144A issues have been non-convertible debt because companies with publicly-traded equity in a US market cannot issue equity under Rule 144A.11 Equity offerings under Rule 144A have increased, however, as companies seek to avoid regulation under the Sarbanes-Oxley Act and foreign issuers seek access to the US market without incurring the costs, including fuller disclosures and increased compliance, of a public US offering.12 In 2002, Rule 144A equity offerings were $40 billion, and in 2006 they were more than $160 billion, representing more than 50 percent of the equity raised in the United States.13

Rule 144A trading platforms have developed in recent years as more issuers seek to raise capital privately. For example, in 2007, Goldman Sachs launched its Tradable Unregistered Equity OTC Market, or GSTrUE, for QIB trading, and the Nasdaq Stock Market’s “PORTAL” system is an electronic platform for the resale of private equity, debt and derivatives.14 The GSTrUE system allows members to view bid and ask offers and recent sales, with actual transactions made through special brokers. These platforms are useful for domestic 144A securities, but typically are not used for foreign IPOs.

Rule 144A and International IPOs

Rule 144A is used in a different context in international investing. While Rule 144A is commonly associated with private placements to institutions in the United States, for offerings outside of the US, Rule 144A is commonly used in the context of public offerings of securities in foreign countries. To understand how underwriters can use Rule 144A in connection with a foreign issuer’s public offering of securities, a dissection of a simple foreign offering is instructive. Consider the example of a foreign company located in France that is selling its stock to the public to raise operating capital. Typically, the issuer will register the offering with the appropriate regulatory body in France and engage a syndicate of underwriting dealers to sell the shares to the French public. This will be called an IPO if this is the first offering of shares to the public by the issuer or a “secondary offering” if it is not an IPO. By virtue of the French registration, the underwriters will be able to sell the shares to the French public. Moreover, the shares will be listed on a French exchange.

There also may be an appetite for the shares outside of France, perhaps including prospective buyers in the United States and other countries. The French registration, however, does not qualify the securities for offer or sale to the public in the United States or other jurisdictions, so an exemption from registration under the US securities laws needs to be found. A common exemption used for this purpose is the private placement exemption under Rule 144A for offers and sales to US QIBs.15 A foreign public offering, therefore, will often be available to the public in the country of registration and be available as a private placement to US QIBs (and possibly to institutions in other countries under similar private placement or institutional buyer exemptions). Similarly, most foreign rights offerings or grants of rights to existing shareholders to purchase additional securities of the issuer at a set price, typically below the current market price, are available only in the United States if the purchaser is a QIB.16

A Pitfall—the Client (NOT the Investment Manager) Must Be the Eligible QIB

In a foreign IPO offered as a private placement to US QIBs, the underwriter will typically require US investors to sign a representation letter—colloquially referred to as a “big boy letter”—in which the investor represents that it is a QIB and makes other standard investment representations. The big boy letter also will include the buyer’s agreement to transfer the securities only to another QIB in a transaction meeting the requirements of Rule 144A or pursuant to another available exemption from registration. When a US investment manager purchases securities for its institutional clients under Rule 144A, it will normally not be feasible to have an authorized signatory of each client sign the big boy letter. Rather, a typical procedure is for the investment manager to sign the big boy letter on behalf of its eligible QIB clients pursuant to its express or implied authority under its power of attorney in the clients’ investment management agreements. In doing so, the manager must ensure that only US clients who are
QIBs are participating, and that its clients who are not QIBs are not participating.

Each participating client must fall within one or more of the QIB categories of eligibility, which include a number of specifically listed types of entities and institutions with at least $100 million in securities investments. One common pitfall is to rely, or to attempt to rely, on the “registered investment adviser” category of the rule in order to satisfy the eligibility requirement. While the international investment manager may be a “registered investment adviser,” a close reading of the QIB definition shows that the definition only refers to a buyer “acting for its own account or the accounts of other qualified institutional buyers.”

Thus, there is a problem for managers in the text of Rule 144A that essentially eliminates the usefulness of the adviser exemption category. Because advisers almost always purchase securities for the accounts of their clients and will not themselves beneficially own the 144A securities, the adviser QIB category is seldom available. This is true even if a manager is managing a commingled vehicle or hedge fund under an investment advisory contract. The commingled vehicle or fund will be the owner of the securities, not the adviser. Even if a hedge fund is structured as a limited partnership or limited liability company, with the registered investment adviser as general partner or managing member, the securities will normally be purchased for the account of the limited partnership or the limited liability company, not for the account of the general partner or managing member.

Although the international investment manager may have the requisite expertise and sophistication to evaluate the risks associated with Rule 144A securities, and the investment manager may be making the same decision, for example, for institutional client A with $105 million in securities investments and institutional client B with $95 million in securities investments, the investment manager may only purchase the 144A securities for client A. Because this outcome does not make sense, and “investment adviser” appears on a long list of eligible institutions such that it seems to be available, it is easy for the manager to make an inadvertent mistake. Unfortunately, the rule’s effect is that 144A securities should not end up directly in the accounts of US shareholders who do not have the threshold amount in their investment portfolio, no matter the sophistication of the manager’s investment team.

Thus, it is important that investment managers know and document their clients’ status as QIBs. This can be done by memorializing facts known to the manager about the client that confirm it is an eligible institution with at least $100 million in securities investments. Section (d) of Rule 144A and the Rule 144A Adopting Release, although written for sellers relying on the rule, provide some guidance and a non-exclusive list of methods for establishing the QIB status of a party. In the simplest case, if the client is an entity in one of the institutional categories listed in the rule and has over $100 million invested with the manager, the manager knows the client is an eligible QIB. The investment manager also may obtain information about the amount of a client’s securities investments through research of public records. Note, however, that public searches are difficult and less useful for private pension plans, foundations, and other private institutions that do not publish sufficient information about their investments.

In many cases, the manager will not be responsible for managing a client’s entire portfolio or may have difficulty obtaining reliable information about the client’s investments. Thus, as a best practice, investment managers should consider documenting a client’s QIB status with a certification signed by the client’s chief financial officer, a person fulfilling an equivalent function, or other executive officer of the client. It is also a good practice to renew these certifications periodically.

There are potentially serious consequences if the investment manager misrepresents its client’s QIB status in completing a big boy letter. The manager will have possibly blown the issuer’s or underwriter’s exemption from Section 5 of the 1933 Act, which could expose the issuer or underwriter not just to liability from the manager and its clients, but also from all persons that purchased the securities in the offering. Under Section 12(a)(1) of the 1933 Act, securities purchasers have a right to rescind the transaction (or to damages if they have sold the securities already), which essentially gives the purchaser a free “put option” with the purchase price as the strike price. Because of the threat and possible cost of such liability, big boy letters typically contain provisions in which the purchaser indemnifies the seller against damages and legal costs from lawsuits to enforce these rights. Put another way, a manager’s clients who are not QIBs effectively insure the stock price of all other purchasers in the IPO, which of course ultimately means the manager is the insurer since it will be liable to its non-QIB clients under their investment management contracts.
Another Pitfall—Investment Guidelines Prohibiting Private Placements

Many institutional clients, like public and private pension plans, endowments and foundations, prohibit investment in “private placements” or “restricted securities.” These clients, or often their consultants, generally categorize investments as equities, fixed income, and alternatives. The alternatives category is generally for allocations to hedge funds, private equity, direct investments in real estate, commodities and similar investments, so that the guidelines for alternatives mandates often will permit investments in derivative instruments and private placements. In contrast, the guidelines for traditional equity and fixed income mandates often will restrict investments in derivatives and “private placements,” with the intent of promoting liquidity. These restrictions, however, can have unintended consequences: Because most foreign IPOs and rights offerings are sold, if at all, only to US QIBs as private placements under Rule 144A, the client could be prevented, by its own guidelines, from investing in foreign IPOs or rights offerings. Accordingly, when negotiating investment guidelines, international equity investment managers should ensure that clients who restrict or prohibit investments in “private placements” or “restricted securities,” agree on an exception for either all 144A securities, or at least for 144A securities issued in connection with a foreign public offering or rights offering.

Disposing of 144A Securities—Application of Regulation S

Once the investment manager has acquired 144A securities in a foreign IPO for its US clients, disposing of the securities is typically simpler. US securities laws apply to offers and sales of securities so that when an investment manager resells the Rule 144A securities for clients, as with the original purchase, the sale must be registered or an exemption must apply. Two commonly used exemptions for resales of Rule 144A securities are resales to QIBs using Rule 144A and resales in an “offshore transaction” in reliance on Regulation S under the 1933 Act. Usually, reselling 144A securities that were obtained in a foreign IPO in an offshore transaction is the simplest and most cost-efficient method. Reselling the securities to another QIB in the US requires the selling client (and the investment manager acting on its behalf) to have the requisite reasonable belief that the buyer is a QIB, which requires a degree of understanding and contact with the buyer that is not always simple or practical.

For international equity managers, resales are typically effected via a foreign exchange. Global brokers typically do not request further representations from an investment manager when selling 144A securities over foreign exchanges (so that liquidity will not be affected). For these transactions, investment managers can look to Regulation S. Regulation S confirms that US securities registration laws apply only within the United States:

For the purposes only of Section 5 of the [1933] Act, the terms offer, offer to sell, sell, sale, and offer to buy shall be deemed to include offers and sales that occur within the United States and shall be deemed not to include offers and sales that occur outside the United States. 21

Thus, resales of securities, including 144A securities, “outside the United States” will not be subject to the registration requirements of the 1933 Act.

For a transaction to qualify under Regulation S outside the United States, the offer or sale must be made in an “offshore transaction” and without any directed selling efforts in the United States. 22 For a resale to be in an “offshore transaction,” the offer must not be made to a person in the United States. This typically will be the case when transacting on a foreign exchange, and Regulation S provides a concrete means to satisfy the “offshore transaction” category by including transactions executed through a “designated offshore securities market” listed in the rule. Rule 902(b) explicitly lists a number of major exchanges around the world 23 and also provides the SEC Staff the authority to designate additional exchanges, listing factors for the Staff to consider in determining whether to add a new exchange. 24 Pursuant to this authority, the SEC Staff has expanded the list since the promulgation of Regulation S. 25

A Note on Resales of 144A Securities in Emerging Markets

Although the list of “designated offshore securities markets” has been expanded, it does not cover every exchange around the world, including many emerging market stock exchanges. Thus, when attempting to sell securities on
an emerging market exchange, the certainty of using a designated exchange is not available and the investment manager must look to the more subjective definition of “offshore transaction.” Under this definition, the sale will be an offshore transaction if the offer is not made to a person in the United States and, at the time the buy order is originated, the buyer is outside the United States or “the seller and any person acting on its behalf reasonably believe that the buyer is outside the United States.”26 As noted above, in most cases, the manager executing through an exchange—even one in an emerging market—may reasonably believe that the buyer will be outside of the United States, but this will be a case-by-case review depending on the mechanics of the particular exchange.

Conclusion

Rule 144A offerings provide foreign issuers a useful way to gain access to the US institutional investor market without bearing the costs of the registration requirements of the 1933 Act, and Regulation S provides the US investor with a simple means to resell in the foreign secondary markets. These rules have resulted in greater and cheaper exposure to international equities for the US retail investor who invests through mutual funds or participates in a pension plan, and as such, they are a regulatory success story. Nonetheless, the rules are highly technical and not always intuitive in their application, and the international investment manager must be on guard against, and prepare for, potential pitfalls that could offset the benefits of the exemptions the rules afford.

NOTES


2. Rule 144A is necessary only for US clients. Non-US clients can participate in foreign IPOs if an exemption from registration or qualification is available in the client’s country of residence. Most non-US developed countries have private placement or institutional investor exemptions that apply to permit institutions to purchase shares in foreign IPOs. Nonetheless, the investment manager should also understand these laws when purchasing and selling for non-US clients.

3. Section 4 of the 1933 Act provides exemptions from the registration requirements of Section 5 of the 1933 Act. Safe harbors, such as those under Regulation D and Regulation S, also may allow sales of unregistered securities in private placements or to non-US persons, provided the various conditions of the relevant safe harbor are satisfied.


5. Rule 144A, Preliminary Note 2.

6. Rule 144A(b).

7. Rule 144A(c).

8. Most of these entities are defined by reference to other statutes.

9. Rule 144A(a)(1).


11. Id.

12. Id. at 16 (citing Tang (2007)).

13. Id.

14. To facilitate DTC-eligibility for 144A securities, the SEC recently issued an order removing the prior requirement for non-investment grade 144A securities to be included in an “SRO Rule 144A System” such as the PORTAL Market System, in part because PORTAL failed to develop as anticipated to include safeguards to facilitate its ability to monitor compliance with Rule 144A. SEC Release No. 34-59384 (Feb. 11, 2009).

15. Less commonly, foreign IPOs can be made available in the United States to “accredited investors” under Regulation D of the 1933 Act.

16. Many rights will themselves be tradable prior to their conversion date. Although non-QIBs may be ineligible to exercise the rights, they may be able to accept and sell them if they are tradable. See Rule 801 et seq. under the 1933 Act.

17. Rule 144A(a)(1)(i). While the investment manager may be able to aggregate assets under management with its proprietary holdings to purchase 144A securities for itself, this is rarely useful because the investment manager is more likely to be investing for clients. See SEC Rel. No. 33-6862, April 23, 1990 (144A Adopting Release) (noting that eligibility of an investment adviser is determined by aggregating proprietary securities holdings with those under management, and allowing other types of institutions to do the same).

18. Section (d) of Rule 144A provides:

In determining whether a prospective purchaser is a qualified institutional buyer, the seller and any person acting on its behalf shall be entitled to rely upon the following non-exclusive methods of establishing the prospective purchaser’s ownership and discretionary investments of securities:

i. The prospective purchaser’s most recent publicly available financial statements. Provided That such statements present the information as of a date within 16 months preceding the date of sale of securities under this section in the case of a U.S. purchaser and within 18 months preceding such date of sale for a foreign purchaser;

ii. The most recent publicly available information appearing in documents filed by the prospective purchaser with the Commission or another
United States federal, state, or local governmental agency or self-regulatory organization, or with a foreign governmental agency or self-regulatory organization, Provided That any such information is as of a date within 16 months preceding the date of sale of securities under this section in the case of a U.S. purchaser and within 18 months preceding such date of sale for a foreign purchaser;

iii. The most recent publicly available information appearing in a recognized securities manual, Provided That such information is as of a date within 16 months preceding the date of sale of securities under this section in the case of a U.S. purchaser and within 18 months preceding such date of sale for a foreign purchaser; or

iv. A certification by the chief financial officer, a person fulfilling an equivalent function, or other executive officer of the purchaser, specifying the amount of securities owned and invested on a discretionary basis by the purchaser as of a specific date on or since the close of the purchaser’s most recent fiscal year, or, in the case of a purchaser that is a member of a family of investment companies, a certification by an executive officer of the investment adviser specifying the amount of securities owned by the family of investment companies as of a specific date on or since the close of the purchaser’s most recent fiscal year.[

The 144A Adopting Release reiterates that the bases for reliance listed in Rule 144A are non-exclusive, and that other factors can be used. It does note, however, that the seller could not rely on certifications that it knew, or was reckless in not knowing, to be false.

19. Rule 144A(d).

20. The 144A Adopting Release elaborates that: “Whether or not the foregoing information [in categories (i), (ii), or (iii) of the rule] is available, the seller and any person acting on its behalf also may rely on a certification by the purchaser’s chief financial officer, or another executive officer, specifying the amount of securities owned and invested on a discretionary basis by the purchaser as of a specific date on or since the close of the purchaser’s most recent fiscal year.”


22. Given the ease of resales on a foreign exchange, the investment manager would rarely be seeking, or needing to seek, buyers in the United States.

23. Rule 902(b)(1). The rule lists: the Eurobond market, as regulated by the International Securities Market Association; the Alberta Stock Exchange; the Amsterdam Stock Exchange; the Australian Stock Exchange Limited; the Bermuda Stock Exchange; the Bourse de Bruxelles; the Copenhagen Stock Exchange; the European Association of Securities Dealers Automated Quotation; the Frankfurt Stock Exchange; the Helsinki Stock Exchange; The Stock Exchange of Hong Kong Limited; the Irish Stock Exchange; the Istanbul Stock Exchange; the Johannesburg Stock Exchange; the London Stock Exchange; the Bourse de Luxembourg; the Mexico Stock Exchange; the Borsa Valori di Milan; the Montreal Stock Exchange; the Oslo Stock Exchange; the Bourse de Paris; the Stock Exchange of Singapore Ltd.; the Stockholm Stock Exchange; the Tokyo Stock Exchange; the Toronto Stock Exchange; the Vancouver Stock Exchange; the Warsaw Stock Exchange and the Zurich Stock Exchange.

