

SEC RULE 144A AND THE GLOBAL MARKET

Bo James Howell*

I. INTRODUCTION

THE RISE OF GLOBALIZATION has created interdependency between domestic and foreign securities markets that require states to evaluate their regulation of foreign investment. The number of international security transactions and the expansion of markets have increased at exponential rates.¹ One unique area of growth is the U.S.-based 144A market. This “resale” market is, and has been for over a decade, the fastest growing securities market in the United States. Rule 144A² allows foreign and domestic issuers and resellers to avoid registration and disclosure standards required in a public security transaction. Through 144A, many corporations, particularly foreign corporations, have been able to raise substantial amounts of capital by initiating private placement transactions which benefit from the efficient 144A resale market. The market allows corporations to reach large financial institutions and, eventually, the retail U.S. investor.

The relaxation of disclosure and registration requirements promotes this modern method of capital formation and the resulting growth should be continued under limited circumstances.³ As established in the final version of Rule 144A, the United States’ Securities Exchange Commission (“SEC”) agreed to monitor the 144A market and to periodically reevaluate it. After seventeen years of phenomenal success, it is time that the SEC revisited Rule 144A to determine if the rule should be opened to small- or medium-sized institutions.

The SEC has recognized that greater flexibility with disclosure and registration requirements is necessary to promote foreign capital formation.⁴ In order to facilitate this goal, the SEC relaxed certain

* B.A. (Washington State University); J.D. (Gonzaga University, 2008)

¹ Teo Guan Siew, “Regulatory Challenges in the Development of a Global Securities Market—Harmonization of Mandatory Disclosure Rules” (2004) Sing. J. Legal Stud. 173.

² Rule 144A entered into force on 30 April 1990, although it had been considered previously. See J. Williams Hicks, *Resales of Restricted Securities*, § 7:1, f.n.1 (2007).

³ Siew, *supra* note 1 at 173.

⁴ Emmanuel U. Obi, “Foreign Issuer Access to U.S. Capital Markets—An Illustration of the Regulatory Dilemma and an Examination of the Securities and

registration and disclosure requirements when it adopted Rule 144A in 1990.⁵ Rule 144A modifies the “U.S. regulatory framework in a manner that renders it more welcoming to foreign participation and investment.”⁶ In short, Rule 144A provides a non-exclusive safe harbor—from s.5 of the *Securities Act*—for non-issuer private resales of restricted securities. Together with s.4, Regulation D, and Regulation S, Rule 144A creates a safe harbor that allows foreign issuers to easily raise capital within the United States.

Once enacted, Rule 144A quickly became a “stepping stone” for foreign issuers looking to enter the United States securities markets.⁷ The promulgation of Rule 144A began a “golden age”⁸ for foreign issuers. For almost two decades, the 144A market has grown exponentially. Today, the 144A market is the second largest securities market in the United States; the public market is still the largest.

This paper focuses on the creation, success, and future of Rule 144A. In Part II, this paper briefly presents the *Securities Act of 1933* and discusses the various sections which created Rule 144A. Part III introduces Rule 144A, including its history, purpose, requirements, and practical application. Part III presents the numbers of the 144A market, which illustrate its exponential growth and success. Part IV discusses the global impact of Rule 144A and its interaction with the *Sarbanes-Oxley Act*. Finally, Part V looks to current global issues affecting Rule 144A and calls for the SEC to follow through with its initial commitment to periodically re-evaluate the rule.

II. THE SECURITIES ACT OF 1933

IN 1933, THE UNITED STATES CONGRESS passed the *Securities Act*, which was primarily intended to “protect unsophisticated [...] investors [...] from fraud.”⁹ Since the passage of the *Securities Act*, private

Exchange Commission’s Response” (2006) 12-SUM L. & Bus. Rev. Am. 399 at 406.

⁵ *Ibid.* at 407.

⁶ *Ibid.* at 407-408.

⁷ Robert G. DeLaMater, “Recent Trends in SEC Regulation of Foreign Issuers: How the U.S. Regulatory Regime is Affecting The United States’ Historic Position as the World’s Principal Capital Market” (2006) 39 Cornell Int’l L.J. 109 at 113. Foreign issuers could enter the 144A market, which has relaxed registration and disclosure requirements, and then jump to the public market once they could satisfy the heightened requirements. *Ibid.*

⁸ *Ibid.*

⁹ Miles Livingston & Lei Zhou, “The Impact of Rule 144A Debt Offerings Upon Bond Yields and Underwriter Fees” *Financial Management Association* (Winter,

placements have been the primary means for avoiding SEC registration and disclosure requirements.¹⁰ Sections 4(1) and 4(2) are two methods of private placement that were created by the SEC. These rules, however, inhibited the liquidity and resale of private placement securities.¹¹ Eventually, the restrictions on resales of private placements led to the creation of Rule 144A, which is grounded in the court-created “Section 4(1-1/2).”¹²

A. Section 4(1): Private Placements and Public Resale of Unrestricted Securities

Section 4(1) of the *Securities Act* exempts from registration any reseller of securities who is not an issuer, underwriter, or dealer.¹³ Under s.4(1) and SEC Rule 144, a party with a private placement holding may sell an unrestricted security on the public market after a set holding period.¹⁴ Initially, the scope of s.4(1) and Rule 144 did not include private resales of restricted securities.¹⁵ A seller wishing to resell a restricted security, therefore, would have to sell it in a “private” transaction in order to satisfy s.4(1).¹⁶

2002) at 2, online: Looksmart
<www.findarticles.com/p/articles/mi_m4130/is_4_31/ai_96904308>.

¹⁰ Susan Chaplinsky & Latha Ramchand, “The Impact of SEC Rule 144A on Corporate Debt Issuance by International Firms” (2004) 77:4 J. of Business 1073 at 1077.

¹¹ *Ibid.*

¹² See Hicks, *supra* note 2, § 7:43 (citing Release No. 6806 at 89, 538-89 & 539).

¹³ Section 2(a)(4) defines an issuer as “every person who issues or proposes to issue any security” and includes a natural person as well as corporations. *U.S. v. Rachal*, 473 F. 2d 1338 at 1341 (5th Cir. 1973), *certiorari denied* 412 U.S. 927. An underwriter is defined as any person who has purchased a security from an issuer with intent to distribute or resell the security. 15 U.S.C. §77b(2)(a)(11). Finally, a dealer is any person that is a full- or part-time broker who deals in securities trading. 15 U.S.C. §77b(2)(a)(12).

¹⁴ Robert B. Robbins, “Offers, Sales and Resales of Securities under Section 4(1-1/2) and Rule 144A” (2006) SM050 ALI-ABA 177 at 179. Rule 144 allows anyone who satisfies its conditions to resell because they will not be considered an underwriter. *Ibid.*

¹⁵ *Ibid.* A restricted security is one that has not satisfied the required holding period.

¹⁶ *Ibid.*

B. Section 4(2): Private Placement, but Restricted Resale

Section 4(2) of the *Securities Act* exempts from registration issuers of securities disbursed in private placements.¹⁷ Unlike s.4(1) and Rule 144, however, s.4(2) applies only to *issuers and not resellers* of private placement securities.¹⁸ The s.4(2) exemption only applies to private offerings that are intended for investment, as opposed to resale.¹⁹ The restriction on resale is reflected in the required two-year holding period.²⁰ The result of s.4(2) is an illiquid market that “requires users to pay a premium to investors that generally can be avoided by issuing in markets other than the U.S.”²¹

C. Section 4(1-1/2): Limited Resale of Restricted Securities

Section 4(1-1/2) is a reaction to the limitation on the resale of securities under s.4(1). In fact, the section is a “case-law derived exemption” and is not located within s.4 of the *Securities Act*.²² Essentially, s.4(1-1/2) is a means of reselling restricted securities while maintaining compliance with s.4(1).²³ In order to maintain compliance with s.4(1), a restricted security had to be sold privately.²⁴ A transaction was considered private, for the purposes of s.4(1-1/2), if six conditions were satisfied: (1) there were less than 25 purchasers; (2) the seller did not engage in public advertising or general solicitation; (3) the seller provided as much information as he or she had about the issuer; (4) if the seller was affiliated with the issuer, then the buyer needed to be sophisticated enough to “fend for themselves”; (5) the seller did not purchase the securities with an intent to resell²⁵; and (6) the purchaser represented that he or she was not acquiring the securities for resale.²⁶

¹⁷ *Ibid.*

¹⁸ *Ibid.*

¹⁹ Hal S. Scott, *International Finance: Transactions, Policy, and Regulation*, 12th ed. (New York: Foundation Press, 2005) at 72.

²⁰ *Ibid.*

²¹ *Ibid.*

²² Cynthia M. Krus & Harry S. Pangas, “FAQs: Rule 144A” Part A, online: RR Donnelley Real Corporate Lawyer <<http://www.realcorporatelawyer.com/faqs/faq144a.html>>.

²³ Robbins, *supra* note 14 at 179.

²⁴ *Ibid.*

²⁵ It is generally held that a holding period of six months or more satisfies the intent requirement. *Ibid.* at 180.

²⁶ *Ibid.* at 179-80.

D. Section 4(3): The Broker-Dealers Door to Rule 144A

Eventually, s.4(3) of the *Securities Act* allowed dealers to utilize the exemption and safe-harbor under Rule 144A. The section allows dealers who are not participating in a distribution to resell the security.²⁷ Since transactions under Rule 144A are not distributions, dealers can utilize the rule to resell restricted 144A securities.²⁸ As a result, dealers utilizing Rule 144A are not underwriters to the transaction.²⁹

III. SEC RULE 144A

A. A Reaction to Resale Limitations

RULE 144A IS A REVOLUTIONARY rule that significantly impacts the U.S. securities markets.³⁰ The influence of Rule 144A stems from the fact that private placements can now be resold by an initial purchaser who acts as a financial intermediary between the issuer and “qualified institutional buyers” (“QIBs”).³¹ The rule was meant to address the gaps between ss.4(1), 4(2), and 4(1-1/2). As stated earlier, the s.4(1) exemption is not available for resales of restricted securities. In addition, the s.4(2) exemption is only available for issuers and does not include resales. Although s.4(1-1/2) attempted to bridge the gap between the s.4(1) and 4(2) exemptions, the bridge was too narrow. Under Rule 144A, non-issuers can resell restricted securities to QIBs without holding them for two years or complying with the general SEC registration and disclosure requirements.³² Essentially, this rule creates a new resale market for restricted securities, which allows a bypass of the registration requirements of publicly traded securities.

Rule 144A was a reaction to the limitations under ss.4(1) and 4(2). By creating a liquid market for restricted securities, the SEC created an innovative means for international issuers looking to gain access to U.S. capital markets.³³ Rule 144A creates a market with increased liquidity and decreased premiums.³⁴ The result is a complete success, as

²⁷ 14 Guy P. Lander, *U.S. Securities Law for International Financial Transactions and Capital Markets*, 2d ed. (2005), § 5.20, 5-25.

²⁸ *Ibid.*

²⁹ *Ibid.*

³⁰ Charles J. Johnson, Jr. & Joseph McLaughlin, *Corporate Finance and the Securities Laws*, 3d ed. (2004) at 501.

³¹ *Ibid.* at 502.

³² Chaplinsky & Ramchand, *supra* note 10 at 1073.

³³ *Ibid.* at 1073-74.

³⁴ Scott, *supra* note 19 at 72.

more international issuers move from the heavily regulated public market to the deregulated 144A market.³⁵

B. An Institutional Rule

Rule 144A was developed for institutional investors who wanted to quickly and easily resell their purchases.³⁶ This was particularly true for foreign issuers who, because of their limited access to U.S. markets and limitations on resales, were often unable to obtain a favorable price for their securities.³⁷ Rule 144A was promulgated as a codification of s.4(1-1/2).³⁸ The result was “increased liquidity and efficiency in international capital markets” and increased access to U.S. private placement markets for foreign issuers.³⁹ Today, “[h]undreds of billions of dollars are sold in 144A transactions each year.”⁴⁰

Initially, the proposed SEC rule “provided a safe harbor for three tiers of transactions.”⁴¹ The three tiers were various sizes of institutional investors.⁴² During the comment phase, it was recommended to the SEC that they take a multi-stage approach.⁴³ As a result, the SEC re-proposed Rule 144A and narrowed its application to large institutional investors.⁴⁴ Since its adoption in 1990, the SEC has not revisited the definition of “qualified institutional buyer” nor has it extended the safe harbor to small or medium institutions.

C. Purpose of Rule 144A

Rule 144A is intended to: (a) facilitate “a more liquid and efficient institutional resale market for unregistered securities”; (b) remove uncertainties about the legitimacy of resales to institutional buyers; and (c) make the U.S. market more attractive to foreign issuers, thus enhancing the U.S. market’s competitiveness internationally.⁴⁵

³⁵ See Chaplinsky & Ramchand, *supra* note 10 at 1074 (illustrating that the 144A market has grown in both total value and proportion of total debt issued by foreign firms).

³⁶ Robbins, *supra* note 14 at 180.

³⁷ *Ibid.*

³⁸ *Ibid.*

³⁹ *Ibid.* at 181.

⁴⁰ *Ibid.*

⁴¹ “Resale of Restricted Securities: Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145” 1990 SEC LEXIS 739 at 2 (“Resale of Restricted Securities”).

⁴² *Ibid.*

⁴³ *Ibid.* at 2-3.

⁴⁴ *Ibid.* at 3.

⁴⁵ Hicks, *supra* note 2, § 7:1

The general purpose of Rule 144A serves to create a private market that will benefit institutional investors by creating a safe harbor for anyone who satisfies the required conditions.⁴⁶ The rule also benefits issuers, despite the fact that they do not qualify for the safe harbor. Essentially, the 144A market will allow the issuer to provide private placements at lower costs.⁴⁷ These lower costs arise from the fact that QIBs can avoid the paper, money, and time-intensive Regulation D procedures. Foreign issuers also benefit because the rule facilitates easier access to investment funds and a more stable alternative to foreign markets.⁴⁸

The practical purpose of Rule 144A was to allow sophisticated investors—financial institutions who could fend for themselves—to resell restricted securities while avoiding “underwriter” status within the meaning of ss. 2(11) and 4(1). Because Rule 144A only applies to large institutional investors, many parties are prevented from utilizing the rule. Retail investors and small or medium institutions, no matter how experienced or knowledgeable, are not considered “sophisticated” enough for 144A purposes. This distinction reflects the SEC’s failure to revisit Rule 144A since its implementation in the early 1990s.

Consistent with the purpose of the *Securities Act*, Rule 144A allows an exemption for resales of restricted securities because the purchasers of the restricted securities are able to “fend for themselves.”⁴⁹ Thus, there is less concern that buyers will be defrauded or misled. Rule 144A creates a nonexclusive safe harbor⁵⁰ from registration requirements if the restricted securities are resold to QIBs.⁵¹ According to the SEC,

⁴⁶ *Ibid.*, § 7:3.

⁴⁷ *Ibid.*

⁴⁸ *Ibid.*

⁴⁹ Chaplinsky & Ramchand, *supra* note 10 at 1078. Hicks, *supra* note 2, § 7:1.

⁵⁰ Nonexclusive safe harbor means “the failure to fully comply with the particular rule [...] does not preclude reliance on another exemption that may be applicable.” Hicks, *supra* note 2, § 7:1, f.n. 3.

⁵¹ *Ibid.*, § 7:1. Rule 144A(a)(1)(i) contains a list of eight categories of buyers that are considered “qualified institutional buyers” if all other conditions are satisfied. These eight categories include:

(A) Any insurance company as defined in section 2(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.

(B) Any investment company registered under the Investment Company Act or any business development company as defined in section 2(a)(48) of that Act;

Rule 144A is “the first step toward achieving a more liquid and efficient institutional resale market for unregistered securities.”⁵² In addition to providing registration and disclosure exemptions, Rule 144A is much faster than a standard public offering.⁵³ The amount of time necessary to complete a Rule 144A transaction is approximately half the time required for public offerings.⁵⁴

Rule 144A impacts both the resale of restricted securities, which was the primary purpose of the rule, and initial private placements.⁵⁵ The rule creates a ripple effect because “it clarifies and codifies the theory behind permissible resale of privately sold securities in a manner that both permits the simplification of procedures applicable to original

- (C) 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;
- (D) 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;
- (E) Any employee benefit plan within the meaning of title I of the Employee Retirement Income Security Act of 1974;
- (F) 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)(ii) (D) or (E) of this section, except trust funds that include as participants individual retirement accounts or H.R. 10 plans;
- (G) Any business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;
- (H) 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
- (I) Any investment adviser registered under the Investment Advisers Act.

¹⁷ C.F.R. § 230.144A(a)(1)(i).

⁵² *Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145*, Sec. Act Release No. 6862, File No. S7-23-88, 1990 WL 311657 at 3 (23 April 1990) [“Release No. 6862”]. The National Association of Securities Dealers (“NASD”) created PORTAL (Private Offering, Resale and Trading through Automated Linkages) as a market for the primary and secondary trading of Rule 144A transactions. Hicks, *supra* note 2, § 7:1.

⁵³ Scott, *supra* note 19 at 73.

⁵⁴ See *ibid.* (noting that a public offering takes 8-15 weeks to complete, while a Rule 144A offering requires only 6-8 weeks).

⁵⁵ 1 Edward F. Greene et al., *U.S. Regulation of the International Securities and Derivatives Markets*, 4th ed. (1997) at 4-16, § 4.03.

private offerings and facilitates such resales.”⁵⁶ Essentially, the 144A market promotes the issuance of private placements by creating a competitive means to resell the restricted securities. The end result is increased marketability for the original offering.⁵⁷ Further, the lack of trading restrictions and the non-exclusive nature of the 144A transaction makes it much more attractive to both foreign and domestic corporations.

D. Requirements of Rule 144A

Rule 144A requires that six conditions be satisfied.⁵⁸ First, the “[i]ssuer cannot be subject to Investment Company Act of 1940 (Investment Company Act) regulation.”⁵⁹ Second, the restricted security must be eligible—this is known as the Non-fungibility requirement. Third, the buyer must be a QIB.⁶⁰ Fourth, buyer notification requirements must be satisfied. Fifth, Rule 144A has certain information requirements.⁶¹ Finally, there is a general prohibition against solicitation.⁶²

By its very terms, Rule 144A is a resale rule, and transactions conducted within its provision are not distributions.⁶³ For 144A purposes, non-issuers are not considered underwriters under “sections

⁵⁶ *Ibid.*

⁵⁷ *Ibid.*

⁵⁸ The language of the rule only lists four requirements, see 17 C.F.R. § 230.144A(d), but the first, fifth, and sixth requirements have developed as a result of practice and other conditions. Hicks, *supra* note 2, § 7:1. The fifth implied condition, a prohibition against general solicitation, has been held to “flow from the nature of the transaction.” *Ibid.*, § 7:2. The rule, however, does not expressly prohibit general solicitation. Johnson & McLaughlin, *supra* note 30 at 502.

⁵⁹ Lander, *supra* note 28 at 5-26, §5.20. “[T]he securities offered or sold cannot be securities of an open-end investment company, unit investment trust, or face-amount certificate company that is or is required to be registered under the Investment Company Act.” *Ibid.* at 5-27, § 5.22 (citing Securities Act Rule 144A(d)(3)(ii), 17 C.F.R. § 230.144A(d)(3)(ii)).

⁶⁰ Chaplinsky & Ramchand, *supra* note 10 at 1078.

⁶¹ *Ibid.* at 1078-79. “Generally speaking, Rule 144A requires issuers to provide a brief statement of the issuer’s business, its products and services, and financial statements [...] for the proceeding [two] years.” *Ibid.* at 1079. This condition is only required if the issuer is not “(1) a reporting company under the Exchange Act, (2) a foreign issuer exempt from the 1934 Act reporting pursuant to Rule 12g3-2(b), and (3) a foreign government eligible to register its securities in the United States.” *Ibid.*; Hicks, *supra* note 2, § 7:2.

⁶² Scott, *supra* note 19 at 74.

⁶³ “Resale of Restricted Securities,” *supra* note 41 at 10.

2(11) and 4(1) of the *Securities Act*.⁶⁴ Dealers are able to take advantage of Rule 144A by utilizing s.4(3). Although an issuer may not utilize Rule 144A, an affiliate of the issue may qualify for the rule.⁶⁵ Further, the securities may eventually be resold to the public by an institution or dealer.⁶⁶ The dealer, however, must still comply with broker-dealer registration requirements under s.15(a) of the *Exchange Act*.⁶⁷

Despite its application, Rule 144A cannot be used as a means of avoiding the registration and disclosure requirements of the *Securities Act*.⁶⁸ To prevent the abuse of Rule 144A, QIBs can only purchase securities for their own accounts or for other QIBs.⁶⁹ Once a QIB has acquired securities through 144A, they may not distribute the purchased security through their managed accounts, such as mutual funds.⁷⁰ As a result, a 144A transaction cannot be used to indirectly distribute securities to U.S. retail investors.⁷¹ A QIB may, however, utilize Rule 144 or Regulation S to reach the retail investor.⁷² In fact, a QIB may tack on the seller's "holding period" for the purposes of qualifying for Rule 144, which allows a restricted security to be sold to a retail investor after a minimum one year holding period.⁷³ A reseller can utilize Regulation S only for resale transactions outside the United States.⁷⁴

In order to be an eligible security under the first requirement of Rule 144A, the security must not be one of two classes of securities.⁷⁵

⁶⁴ *Ibid.*

⁶⁵ Krus & Pangas, *supra* note 22 at Part A.

⁶⁶ *Ibid.*

⁶⁷ "Resale of Restricted Securities", *supra* note 41 at 11.

⁶⁸ *Ibid.* at 12.

⁶⁹ Krus & Pangas, *supra* note 22 at Part B.

⁷⁰ *Ibid.* at Part G.

⁷¹ *Ibid.* at Part H.

⁷² *Ibid.* at Part A.

⁷³ *Ibid.* at Part B. The seller, however, must be unaffiliated with the issuer. *Ibid.*

⁷⁴ *Ibid.* at Part A.

⁷⁵ Rule 144A expressly provides that:

The securities offered or sold:

- (i) Were not, when issued, of the same class as securities listed on a national securities exchange registered under section 6 of the Exchange Act or quoted in a U.S. automated inter-dealer quotation system; Provided, That securities that are convertible or exchangeable into securities so listed or quoted at the time of issuance and that had an effective conversion premium of less than 10 percent, shall be treated as securities of the class into which they are convertible or exchangeable; and that warrants that may be exercised for securities so listed or quoted at the time of issuance, for a period of less than 3 years from the date of issuance, or that had an effective exercise premium of less than 10

Excluded classes of securities include securities that (1) when issued are publicly traded⁷⁶ or (2) are “fungible” securities.⁷⁷ A fungible security is similar to a publicly traded security within the same class.⁷⁸ The purpose of these limitations is to prevent the development of competing public and private markets for the same class of securities.⁷⁹ The SEC, however, has allowed securities issued under Rule 144A to be “exchangeable at the issuer’s election into securities of unrelated issuers.”⁸⁰ Resales of the mandatory exchangeable securities must satisfy either s.4(1) or Rule 144.⁸¹ Finally, the eligibility requirement is determined at the time of resale and subsequent actions, such as listing on the public market, which will not affect the initial transaction.⁸²

percent, shall be treated as securities of the class to be issued upon exercise; and Provided further, That the Commission may from time to time, taking into account then-existing market practices, designate additional securities and classes of securities that will not be deemed of the same class as securities listed on a national securities exchange or quoted in a U.S. automated inter-dealer quotation system; and

- (ii) Are not securities of an open-end investment company, unit investment trust or face-amount certificate company that is or is required to be registered under section 8 of the Investment Company Act.

¹⁷ C.F.R. § 230.144A(d)(3); Hicks, *supra* note 2, § 7:15.

⁷⁶ This class of securities refers to those that are properly registered under section 6 of the *Securities and Exchange Act* and listed on a national exchange or quoted on NASDAQ. Hicks, *supra* note 2, § 7:17. These securities are excluded because they are already available on the public market. *Ibid.*

⁷⁷ *Ibid.*, § 7:15.

⁷⁸ Scott, *supra* note 19 at 73; Hicks, *supra* note 2, § 7:16. The test for “same class” depends on the type of security. For American Depository Receipts (“ADRs”), “where ADRs are publicly traded ‘the deposited securities underlying the ADRs also would be considered publicly traded’ and of the same class. Hicks, *supra* note 2, § 7:19 (citing Release No. 6862 at 08,640) (internal quotations omitted). For common stock a “substantially similar” test is applied. *Ibid.* For preferred equity securities the test is whether the “terms relating to dividend rate, cumulation, participation, liquidation preference, voting rights, convertibility, call, redemption and other similar material matters are substantially identical.” *Ibid.* (citing Release No. 6862 at 80,640). For debt securities the test is whether the “terms relating to interest rate, maturity, subordination, security, convertibility, call, redemption and similar matters are substantially identical.” *Ibid.* (citing Release No. 6862 at 80,640).

⁷⁹ *Ibid.*, § 7:15 (citing SEC Press Release No. 6839 at 80,222-80,223).

⁸⁰ *Mandatorily Exchangeable Issuer Securities*, 1999 SEC No-Act. LEXIS 854 (25 October 1999).

⁸¹ *Ibid.*

⁸² *Ibid.*; *Shearman & Sterling*, 1998 SEC No-Act. LEXIS 1104 (21 December 1998).

The second requirement under Rule 144A is that the buyer must be a QIB.⁸³ The burden of determining whether an entity is a QIB is placed upon the seller. Generally, the seller or any agent of the seller must reasonably believe that a potential buyer is a QIB.⁸⁴ The list of qualifying QIBs is rather broad. Most financial institutions are eligible so long as they can satisfy a securities ownership test. This test requires that the entity own and invest a minimum of \$100 million in non-affiliated securities.⁸⁵ The only exceptions to the securities ownership test apply to registered broker-dealers, whose minimum threshold is ownership or an investment of \$10 million in non-affiliated securities, or in cases where the registered broker-dealer is acting as an agent for a QIB and the transaction will be instantaneous.⁸⁶ Domestic banks⁸⁷ must satisfy the minimum \$100 million threshold and have an audited net worth of \$25 million or more within the preceding 16 months.⁸⁸ Foreign banks are allowed 18 months.⁸⁹ There are number of ways to determine if an institution is a QIB, including: (1) the published financial statements of the institution; (2) other publicly available information filed with any regulatory authority; (3) information published in a recognized securities manual;⁹⁰ (4) certification from the institution's chief financial officer or

⁸³ See 17 C.F.R. § 230.144A(a)(i)-(vi) for the complete definition of a qualified institutional buyer.

⁸⁴ Hicks, *supra* note 2, § 7:21. The SEC has held that the QIB list from CommScan and Communicator Inc. are satisfactory sources of reasonableness, so long as the entities have been listed for the past 16 months for U.S. purchasers and 18 months for foreign purchasers. *Ibid.* Further, the seller must not know or have reason to know that the information submitted by the buyer is fraudulent or a misrepresentation. *Ibid.*

⁸⁵ *Ibid.*, § 7:21. The \$100 million threshold ensures that the entity is sophisticated enough to "fend for itself." *Ibid.* The purpose of these limitations is to prevent indirect distributions of restricted securities. *Ibid.*, § 7:24.

⁸⁶ *Ibid.*, § 7:21.

⁸⁷ According to Section 3(a)(2) of the *Securities Act of 1933*:

[T]he term "bank" means any national bank, or banking institution organized under the laws of any State, Territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official; except that in the case of a common trust fund or similar fund, or a collective trust fund, the term "bank" has the same meaning as in the Investment Company Act of 1940 [15 U.S.C.A. § 80a-1 et seq.].

15 U.S.C. § 77c(a)(2).

⁸⁸ Hicks, *supra* note 2, § 7:21 (citing 17 C.F.R. § 230.144A(a)(vi)).

⁸⁹ *Ibid.*

⁹⁰ Standard & Poor's, 1991 SEC No-Act. LEXIS 847 (8 July 1991).

similar senior officer that the institution owns or invests a specified actual amount of securities.⁹¹

The third requirement, buyer notification, imposes a duty on the seller “to ensure that the purchaser is aware that the seller may rely on the exemption from the provisions of Section 5 of the [Securities] Act.”⁹² Although there is no resale restriction, the seller must still inform the buyer that the seller is exempt from registration requirements.⁹³

Finally, the information requirement ensures that the buyer is aware of the chain of transactions and the one-year holding period.⁹⁴ In addition, “certain basic financial information” about the issuer must be provided at the request of the prospective purchaser.⁹⁵ If the issuer provides the SEC with periodic financial reports under the *Exchange Act*, then no additional information needs to be provided.⁹⁶ An exemption from the information requirement is granted to “foreign government[s] eligible to register securities under the Securities Act on Schedule B.”⁹⁷ Further, if an entity unconditionally guarantees the securities of its wholly-owned subsidiary, then such entity may provide its own information, in lieu of the subsidiary, so long as the guarantor (1) is subject to s.13 or 15(d) of the Exchange Act or (2) is exempt from reporting pursuant to Rule 12g3-2(b).⁹⁸

E. Rule 144A in Practice

Rule 144A is an exemption from the registration requirements of the *Securities Act*.⁹⁹ The rule provides protection from violations of the registration and disclosure requirements of s.5, by stating that anyone—other than an issuer or a dealer—who satisfies the requirements of Rule

⁹¹ This includes lists created by institutions who have established a reasonable belief that other institutions are QIBs. *CommScan LLC*, 1999 SEC No-Act. LEXIS 116 (3 February 1999); *Communicator Inc.*, 2002 SEC No-Act. LEXIS 783 (20 September 2002).

⁹² 17 C.F.R. § 230.144A(d)(2). Section 5 is a prohibition against the sale of unregistered securities. The initial seller is protected even if the QIB violates Section 5. *Hicks*, *supra* note 2, § 7:39.

⁹³ “Resale of Restricted Securities”, *supra* note 41 at 6-7.

⁹⁴ *Hicks*, *supra* note 2, § 7:47.

⁹⁵ “Resale of Restricted Securities”, *supra* note 41 at 35.

⁹⁶ *Ibid.*

⁹⁷ *Ibid.* The exemption includes agencies or instrumentalities of the foreign government. *Rule 144A*, 1990 SEC No-Act. LEXIS 840 (30 May 1990).

⁹⁸ *British Aerospace Holdings, Inc.*, 1990 SEC No-Act. Lexis 793 (9 May 1990); *Schering-Plough Corporation*, 1991 SEC No-Act. Lexis 1307 (21 November 1991).

⁹⁹ *Hicks*, *supra* note 2, § 7:2.

144A will not be an underwriter to a distribution transaction.¹⁰⁰ The rationale behind the rule is that a distribution requires a public offering, and resales to QIBs are not public offerings.¹⁰¹ Since 144A transactions are not distributions, the seller does not have to register the security.¹⁰²

Although non-issuers are exempt from the registration requirements under Rule 144A, the rule does not exempt resellers from U.S. antifraud and civil liability provisions.¹⁰³ According to Scott, “[u]nlike registered offerings where liability for failure to disclose or misstatements is quite strict—under Sections 11 and 12(a)(2) of the [Securities Act]—Rule 144A disclosure standards are only subject to Rule 10b-5 where the plaintiff must prove intent or recklessness.”¹⁰⁴ The rule does, however, exempt foreign issuers “from the anti-manipulation rules, Rules 10b-6, 10b-7, and 10b-8, which are designed to prevent issuers, underwriters, and other participants in a securities offering [...] from supporting the price of the securities.”¹⁰⁵

Rule 144A is a resale rule. In reality, however, it is a means of distributing securities. Although the rule was intended to increase the efficiency and liquidity of the secondary market for restricted securities, it has developed into the primary distribution method for private security transactions. Foreign issuers wanting to avoid the reporting requirements of the SEC can do so by utilizing the 144A market. Standardization in the market has led most 144A transactions to be “conducted on an underwritten basis with terms and conditions substantially identical to those applicable to public offerings.”¹⁰⁶ The QIB negotiates with the foreign issuer much like a “traditional” private placement, but the process is more efficient.¹⁰⁷

Although practically speaking, Rule 144A limits transactions to debt securities, the rule has been used for other types of securities. In an SEC No-Action Letter regarding the Institutional Real Estate

¹⁰⁰ 17 C.F.R. § 230.144A; Hicks, *supra* note 2, § 7:1. A dealer may, however, use Rule 144A to rely on Section 4(3) and will not be a participant in a distribution or an underwriter if they satisfy the necessary conditions. Hicks, *supra* note 2, § 7:1. Issuers, however, do not benefit from Rule 144A. *Ibid.*

¹⁰¹ Lander, *supra* note 27 at 5-25, §5.20.

¹⁰² *Ibid.*

¹⁰³ See Hicks, *supra* note 2, § 7:2 (discussing the preliminary notes to Rule 144A).

¹⁰⁴ Scott, *supra* note 19 at 73. The minimal level of financial information required under Rule 144A, however, is waived if the issuer is already registered in the public market or is a foreign issuer who is registered in their home country, pursuant to 12g3-2(b) of the *Securities Exchange Act*. *Ibid.*

¹⁰⁵ *Ibid.* at 75.

¹⁰⁶ Greene et al., *supra* note 55 at 4-5, § 4.01.

¹⁰⁷ *Ibid.*

Clearinghouse System,¹⁰⁸ the Division of Market Regulation allowed two brokerage firms to establish an unregistered real estate securities system, without registering as an exchange or clearing agent, so long as the system met four conditions. The first condition required that any system participant with access to eligible Rule 144A securities must be a QIB.¹⁰⁹

The National Association of Securities Dealers (“NASD”) created a system “for both primary distributions and secondary trading of unregistered securities as well as clearance and settlement of those securities.”¹¹⁰ The 144A market is actually “the NASDAQ’s screen-based automated trading system known as PORTAL, ‘Private Offerings, Resale and Trading through Automated Linkages.’”¹¹¹ PORTAL was initially designed to facilitate the “the clearance and settlement of both domestic and foreign securities” through a closed trading system.¹¹² The system serves a dual purpose. First, PORTAL allows “primary offerings under Section 4(2) or Regulation D [...] to be resold under Rule 144A.”¹¹³ In addition, the system allows “secondary trading under Rule 144A.”¹¹⁴ Although the purpose of PORTAL is to create a medium of exchange for restricted securities, “few securities are actually traded through it.”¹¹⁵

A general 144A transaction has three steps: (1) an issuer provides a notice, under Form 8-K, that it will, is, or has made a Rule 144A private placement offering; (2) an issuer sells restricted securities to a broker-dealer in a private placement offering under s.4(2), Regulation D, or Regulation S; (3) the restricted security is then resold to a QIB under Rule 144A.¹¹⁶ Because Rule 144A has no holding requirement, the broker-dealer can resell to a QIB at anytime.¹¹⁷ Rule 144A can also be combined with American depository receipts (“ADRs”). By using ADRs, the issuer can avoid filing a registration statement with the SEC.¹¹⁸

¹⁰⁸ 1996 WL 279164 [“S.E.C. No-Action Letter”].

¹⁰⁹ *Ibid.*

¹¹⁰ Lander, *supra* note 27, § 5.43, 5-42.

¹¹¹ Krus & Pangas, *supra* note 22 at Part F (citing SEC Release No. 34-27956 (27 April 1990)).

¹¹² Greene et al., *supra* note 55, § 4.05, 4-45.

¹¹³ Lander, *supra* note 27, § 5:43, 5-68.

¹¹⁴ *Ibid.*

¹¹⁵ Krus & Pangas, *supra* note 22 at Part F.

¹¹⁶ *Ibid.* at Part G (citing Preliminary Note No. 7 to Rule 144A and Rule 144A(e) of the 1933 Act).

¹¹⁷ *Ibid.*

¹¹⁸ Lander, *supra* note 27, § 5:33, 5-45. “It is common for foreign issuers to privately place their equity securities under Rule 144A in the form of ADRs or to give the purchaser the option of purchasing ADRs or ordinary shares.” *Ibid.*

Private placement securities are placed in a “restricted” ADR through Rule 144A.¹¹⁹

Regulation S provides a unique method of post-144A resale. A QIB who purchases a restricted security via 144A can then resell the security to investors outside the United States. The two nominal requirements are that (1) the transaction takes place offshore and (2) there is a prohibition against directed selling techniques.¹²⁰ The benefit of an offshore transaction under Regulation S is that the security becomes unrestricted and it can be sold freely in the U.S., once certain minimum holding periods are satisfied.¹²¹ Further, a security that is sold under Regulation S and would otherwise be eligible for Rule 144A can still be utilized in a 144A transaction.¹²² A broker-dealer who purchases the Regulation S security may, within the Regulation S safe harbor period, resell the security to a QIB.¹²³ The underlying rationale is the same as the rationale for Rule 144A: the sale is not a distribution.¹²⁴ Further, the resale is “deemed to occur outside the United States [...] and [...] is] not subject to registration under the *Securities Act*.¹²⁵

IV. IMPACT OF RULE 144A

IN 1991, CONGRESS BEGAN ASKING QUESTIONS about the impact of Rule 144A on securities transactions.¹²⁶ In response, the SEC submitted a report discussing the rule’s impact.¹²⁷ Additional reports would follow in 1993 and 1994.¹²⁸ In general, the SEC reports stated that the rule was fulfilling its purpose of attracting foreign issuers to the United States capital markets and no congressional legislation was needed.¹²⁹ The

¹¹⁹ Lander, *supra* note 27, § 5.32, 5-41.

¹²⁰ Greene et al., *supra* note 55 at 4-26.

¹²¹ *Ibid.* at 4-26 – 4-27.

¹²² *Ibid.* at 4-27.

¹²³ *Ibid.*

¹²⁴ *Ibid.*

¹²⁵ Lander, *supra* note 27, § 5.32, 5-41.

¹²⁶ Hicks, *supra* note 2, § 7:48.

¹²⁷ *Ibid.*

¹²⁸ *Ibid.*

¹²⁹ *Ibid.*

1993 Report¹³⁰ showed that from April 1990 until December 1993, the 144A market had sold \$91.449 billion in securities.¹³¹

In sum, Congress has not tampered with Rule 144A because of the immediate and continued success of the 144A market. Rule 144A is fulfilling its purpose of deregulating securities transactions between sophisticated entities that do not need the enhanced protection of the *Securities Act*. Further, the 144A market is attracting foreign issuers to the United States. Although Rule 144A limits the participants and types of securities transactions, it is clearly broad enough to be a substantial source of capital formation.

The 144A market encompasses many types of domestic and international securities.¹³² The market includes “bonds, medium-term notes, and collateralized instruments.”¹³³ The 144A market was created in 1991 and posted 319 issues worth \$16.4 billion. By 2002, the market had exploded into 2,585 issues worth \$253.7 billion.¹³⁴ Between the private, public, and 144A markets, the 144A market is second in size (behind the public market) and “international issuers represent a much larger proportion [...] than in the other two markets.”¹³⁵ From 1991 to 2002, the public market increased 593 percent and the private market decreased 64 percent.¹³⁶ The 144A market, on the other hand, increased 1,549 percent.¹³⁷

There is also a significant difference between domestic 144A issues and international 144A issues.¹³⁸ Almost every domestic issuer contemporaneously issues a registration application for the public market; while fewer international issuers apply for registration because of the increased costs.¹³⁹ From a foreign issuer’s perspective, the 144A

¹³⁰ U.S., Securities and Exchange Commission, *Staff Report on Rule 144A* (18 August 1994) (1994-1995 Transfer Binder) Fed. Sec. L. Rep. (CCH) [“1993 Report”]. The 1993 Report analyzed information from the adopting of Rule 144A in April 1990 through December 1993. Hicks, *supra* note 2, § 7:48.

¹³¹ *Ibid.*, § 7:49. This amount was approximately 28.03% of the total U.S. securities market. *Ibid.* In addition, almost half of the companies represented by the transactions were foreign. *Ibid.*

¹³² Lucy F. Ackert & Gabriel G. Ramirez, “The Evolving Market for Debt under Rule 144A: The Increasing Importance of Collateralized Obligations” (21 September 2005) at 14, online: Financial Management Association <www.fma.org/Chicago/Papers/SEC144A-AckertRamirez.pdf>. (cited with author’s permission)

¹³³ *Ibid.* at 3.

¹³⁴ *Ibid.* at 5.

¹³⁵ *Ibid.* at 6.

¹³⁶ *Ibid.* at 12.

¹³⁷ *Ibid.*

¹³⁸ Chaplinsky & Ramchand, *supra* note 10 at 1079.

¹³⁹ *Ibid.*

market is now the “market of choice for U.S. equity issues.”¹⁴⁰ In fact, “[i]n 2005, foreign companies raised \$83 billion in 186 equity issues in the Rule 144A market compared to \$5.3 billion in 34 public offerings—that is, 90% of the volume of international equity issues in the United States were done in the private market.”¹⁴¹ Further, the 144A market has increased its share of international equity volume by 40 percent since 1995.¹⁴²

A. Domestic 144A Market

Rule 144A was primarily intended to benefit both small and institutional investors by creating an easy, more efficient method of accessing U.S. capital markets. Although the primary purpose of Rule 144A was to attract foreign issuers, the 144A market is open to and has been utilized by domestic issuers. While the foreign segment of the 144A market has unique differences from the public and private markets, the domestic market mirrors the public and private markets in composition. Despite the difference in internal market structure between the foreign and domestic segments, the requirements for transacting within the 144A market is the same regardless of whether an issuer is foreign or domestic.

As mentioned earlier, the eligibility requirement is determined at the time of issue.¹⁴³ As a result, there is the potential that two separate markets will develop for some 144A securities. Initially, the private placement of eligible securities will create a market in which such securities can continue to be resold so long as Rule 144A is satisfied.¹⁴⁴ The issuer may, however, decide to list the same class of securities on one of the national exchanges, creating a second market.¹⁴⁵ Despite the development of a national public market, the initial 144A market can still be maintained, so long as the requirements under Rule 144A are followed.

The 144A market has grown exponentially since the SEC promulgated the rule in 1990. In 1991, the 144A market was \$16 million and by 2001 it had grown to \$417 billion.¹⁴⁶ Just like the public and private markets, the majority of the proceeds from the domestic 144A market come from bonds (62.2%).¹⁴⁷ Medium-term Notes (“MTNs”)

¹⁴⁰ Practising Law Institute, *Foreign Issuers & the U.S. Securities Laws 2007: Strategies for the Changing Regulatory Environment* (2007) at 74.

¹⁴¹ *Ibid.*

¹⁴² *Ibid.*

¹⁴³ Shearman & Sterling, *supra* note 82 and accompanying text.

¹⁴⁴ Hicks, *supra* note 2, § 7:15.

¹⁴⁵ *Ibid.*

¹⁴⁶ Ackert & Ramirez, *supra* note 132 at 3.

¹⁴⁷ *Ibid.* at 9.

comprise the second largest segment of the 144A market (27.9%), while Collateralized Obligations¹⁴⁸ ("COs") comprise the third largest segment (24.7%).¹⁴⁹

In sum, the domestic segment of the 144A market is clearly thriving and reflects the general success of the entire market. For most domestic issuers who choose to utilize the 144A market, the market is a profitable alternative to listing in the public market. While many domestic issuers will choose to participate in the public and 144A market, the 144A market does offer business an alternative to listing in the more expensive and heavily regulated public market.

B. International 144A Markets

Globalization has encouraged the expansion of transnational securities markets.¹⁵⁰ Today, capital formation is an international process.¹⁵¹ Rule 144A has its greatest impact on foreign issuers because it allows them to "ease into the U.S. market."¹⁵² By 1997, six years after the 144A market opened, the 144A market contained 30 percent of all foreign transactions and 74 percent of total private placements.¹⁵³ For international issuers, the 144A Market segments are considerably different from the domestic market. Unlike the public and private markets, the international 144A Market has no cash deposits ("CDs"), which make up the second largest sector for both the public and private markets.¹⁵⁴ For international issuers, Medium Term Notes ("MTNs") comprise the second largest sector (27.9%).¹⁵⁵ The remaining portion of the international 144A Market consists of Collateralized Obligations ("COs") and other securities.¹⁵⁶

The exponential growth of the 144A market is consistent with global trends, which reflect "[...] an unprecedented period of change and growth."¹⁵⁷ Issuers are looking to expand their investor base, while contemporaneously seeking continued capital formation. Rule 144A provides a more efficient and cost-effective means for foreign investors

¹⁴⁸ "COs are derivative debt securities that are backed by a portfolio of loans, including mortgage, credit card, and automobile debt, among others." *Ibid.* at 10.

¹⁴⁹ See *ibid.* at T4 (tabulating the total proceeds of the various markets).

¹⁵⁰ Stephen J. Choi, "Promoting Issuer Choice in Securities Regulation" (2001) 41 *Va. J. Int'l L.* 815 at 816.

¹⁵¹ Obi, *supra* note 4 at 399.

¹⁵² Scott, *supra* note 19 at 74.

¹⁵³ *Ibid.*

¹⁵⁴ Ackert & Ramirez, *supra* note 132 at T4 (tabulating the total proceeds of the various markets).

¹⁵⁵ *Ibid.*

¹⁵⁶ *Ibid.*

¹⁵⁷ Siew, *supra* note 1 at 190.

looking to tap into U.S. capital. Issuers and investors, in the United States and abroad, will gain access to a wider pool of investors and securities, which will result in lower costs.¹⁵⁸ In essence, Rule 144A relaxes the regulatory requirements for sophisticated entities that need less protection. This limited deregulation is an innovative method of increasing both capital investment and investor pools.

Since 1990, Rule 144A has created an alternative market for foreign corporations wanting access to U.S. capital markets.¹⁵⁹ This alternative private market allows foreign corporations to avoid SEC accounting and registration requirements.¹⁶⁰ Further, Rule 144A recognizes that institutional investors do not need high levels of protection and such investors recognize "the importance of an internationally diversified portfolio."¹⁶¹

When the 144A market opened in 1991, the number of international issues in the public, 144A, and private markets, respectively, were 692, 1,057, and 132, with values of \$25.2, \$8.3, and \$18.9 billion.¹⁶² Between 1992 and 1993, the volume of foreign 144A placements increased 244%, from \$4.3 billion to \$14.8 billion.¹⁶³ Further, from 1991 to 1997, most foreign issuers raised capital in the Rule 144A market.¹⁶⁴ By 2002, the value of the 144A market had increased tenfold and was second in value behind the public market.¹⁶⁵ The rise of the 144A market mirrors the decline of the private market and the 144A market increased at a rate of more than twice the public market.¹⁶⁶

In sum, the 144A Market has surpassed the public market in the number of issues and in value.¹⁶⁷ In comparison to the public market, the 144A is slightly less in value, but has a greater number of issues.¹⁶⁸ The data illustrates that the small number of international issuers in the public market are large firms, which accounts for the larger average

¹⁵⁸ See Edward F. Greene, "Beyond Borders: Time to Tear Down the Barriers to Global Investing" (2007) 48(1) *Harv. Int'l L.J.* 85 at 88 (discussing the benefits of deregulating U.S. financial markets).

¹⁵⁹ Johnson & McLaughlin, *supra* note 30 at 529.

¹⁶⁰ *Ibid.*

¹⁶¹ Siew, *supra* note 1 at 173.

¹⁶² Ackert & Ramirez, *supra* note 132 at 7.

¹⁶³ Hicks, *supra* note 2, § 7:49. This increase, however, was only 12 percent more than the overall increase for Rule 144A placements. *Ibid.*

¹⁶⁴ Ackert & Ramirez, *supra* note 132 at 2.

¹⁶⁵ *Ibid.* at 7. The value in the public, 144A, and private markets were \$192.5, \$85.8, and \$11.7 billion, respectively. *Ibid.*

¹⁶⁶ *Ibid.*

¹⁶⁷ *Ibid.* at 7 & 26.

¹⁶⁸ *Ibid.* at 26.

value (about twice the size of the 144A market).¹⁶⁹ The data reflects the great success that Rule 144A, a limited deregulation rule, has had on restricted securities. In fact, the success of the 144A market has stirred interest in other areas of the world, such as Europe and China, who are looking for both models to implement in their respective markets or alternatives markets for capital formation.

1. Rule 144A and China

The economic growth and development of China over the past few decades have made the country a major player in global securities markets. The acquisition of Hong Kong and its substantial securities market has made the U.S. public market less appealing and necessary. The Hong Kong market possesses “the liquidity to support most of the large IPOs [initial placement offerings] coming out of China.”¹⁷⁰ Chinese issuers can now reach a larger pool of investors and capital formation, without going to the U.S. public market, by utilizing the Hong Kong or London exchanges.¹⁷¹ While increased regulatory requirements have made the U.S. public market less attractive and efficient, the 144A market is still a cost-effective means of tapping U.S. capital.¹⁷² Today, the 144A market is “an attractive alternative for Chinese issuers who want to avoid the costs and delay of the SEC regulatory regime.”¹⁷³

The importance of the Chinese market cannot be ignored. The amount of capital raised by Chinese firms grew 225 percent between 2003 and 2005.¹⁷⁴ In fact, only U.S. firms raised more capital through IPOs in 2005.¹⁷⁵ Today, China boasts the fourth largest economy in the world, but its reliance on U.S. capital formation has decreased.¹⁷⁶ “[B]etween 1993 and 2001, China-based companies raised approximately \$24 billion in [IPOs] in U.S. capital markets, and between 2001 and 2003, raised approximately \$5 billion overall in U.S. capital markets.” Over any three-year period from 1993 to 2001, Chinese firms raised on average \$8 billion in U.S. capital markets, as opposed to just \$5 billion in the three-year period from 2001 to 2003.

The Chinese have four general alternatives to raising capital, including “(1) China’s domestic markets, (2) U.S. markets, (3) the Hong

¹⁶⁹ *Ibid.* at 7.

¹⁷⁰ Erica Fung, “Regulatory Competition in International Capital Markets: Evidence from China in 2004-2005” (2006) 3 N.Y.U. J. L. & Bus. 243 at 245.

¹⁷¹ *Ibid.*

¹⁷² *Ibid.*

¹⁷³ *Ibid.*

¹⁷⁴ Chinese companies raised \$8 billion in 2003 and over \$20 billion in 2005. *Ibid.* at 247.

¹⁷⁵ *Ibid.*

¹⁷⁶ *Ibid.*

Kong market, and (4) markets in the rest of the world.”¹⁷⁷ In regards to the U.S. markets, Chinese companies are beginning to shift their emphasis from the public markets to the 144A market. Rule 144A is an increasingly popular alternative to the public markets, particularly in light of the heightened requirements of the *Sarbanes-Oxley Act*.¹⁷⁸ Rule 144A allows Chinese issuers to utilize the greater liquidity, depth, and efficiency of the U.S. capital markets—which are the largest in the world—while avoiding the inefficient public market requirements.¹⁷⁹ The SEC disclosure requirements make up the major barrier to U.S. public markets, because they substantially raise the cost of registration and disclosure.¹⁸⁰ Rule 144A, on the other hand, relaxes these requirements and, consequently, provides cost-effective access to U.S. capital markets.

The 144A market is necessary to keep the United States competitive in global securities. In fact, the modern trend for Chinese issuers is to move away from the U.S. public listings toward the Hong Kong listings.¹⁸¹ In the past, Chinese firms would have concurrent listings in both the Hong Kong markets and the U.S. market, but 2005 marked a change of course as more Chinese firms became listed solely on the Hong Kong exchange.¹⁸² The amount of capital raised by Chinese firms in the Hong Kong exchange grew more than 300 percent between 2003 and 2005.¹⁸³ In addition, the average IPO on the Hong Kong exchange is quickly closing in on the average IPO in the U.S. public markets.¹⁸⁴

The establishment of the 144A market has encouraged foreign issuers and QIBs to continue raising capital in the United States. Domestic QIBs are now more likely to get involved in foreign markets, which have created a steady supply of U.S. capital to China.¹⁸⁵ Rule 144A allows Chinese issuers to turn to U.S. private placement markets and avoid greater liability under the *Sarbanes-Oxley Act*.¹⁸⁶

¹⁷⁷ *Ibid.* at 249.

¹⁷⁸ *Ibid.* at 258.

¹⁷⁹ See *ibid.* at 260 (noting that deeper liquidity, lower volatility, and tighter spreads than alternative markets make U.S. markets more cost-effective).

¹⁸⁰ *Ibid.* at 262.

¹⁸¹ *Ibid.* at 273.

¹⁸² *Ibid.*

¹⁸³ *Ibid.* at 274. In 2003, Chinese firms raised \$7.5 billion, but by 2005, they were raising \$24.7 billion. *Ibid.*

¹⁸⁴ *Ibid.*

¹⁸⁵ *Ibid.* at 297.

¹⁸⁶ *Ibid.* at 299.

V. GLOBAL ISSUES AND REVALUATION OF RULE 144A

AS GLOBAL MARKETS CONTINUE TO EXPAND and 144A transactions increase, tensions arise between 144A and other issues, such as optimality, convergence, substituted compliance, and increased market competition. Finally, the success of Rule 144A suggests that it is time for the SEC to consider expanding the market to include more QIBs. When the rule was adopted in 1990, the SEC clearly stated that Rule 144A and its subsequent market would be monitored and periodically evaluated. In addition, the 1990 rule was the first step in a multi-tier approach that was meant to consider whether or not the definition of a QIB should be extended to small- or medium-sized institutions. After seventeen years, it is time for the SEC to reconsider Rule 144A and decide whether any changes are appropriate.

Arguably, Rule 144A brings the U.S. security market closer to optimality by allowing foreign issuers, resellers, and large sophisticated institutions to perform highly efficient transactions. Unfortunately, this movement towards optimality does not directly incorporate all investors, particularly retail investors and small or medium institutions.

Markets and market regulation can no longer be supported by an isolationist viewpoint.¹⁸⁷ Recently, the SEC has opened a dialogue regarding “a new framework to apply to foreign financial service providers accessing the U.S. capital market [...].”¹⁸⁸ Essentially, the new framework would create a system of “substituted compliance” that allows foreign exchanges and broker-dealers to avoid direct SEC supervision.¹⁸⁹ In order to qualify, however, the foreign entity would need to be regulated by a system that is “substantially comparable” to the U.S. regime.¹⁹⁰ Although the details of this system are beyond the scope of this paper, the proposed system does come into tension with Rule 144A.

Under the proposed system, select U.S. investors would be able to directly transact with foreign exchanges or broker-dealers who were not registered with the SEC.¹⁹¹ Further, the system would “promot[e] high-quality [international] regulatory standards [...] increase competitions in financial services [...] and lower cross-border transaction costs, to the

¹⁸⁷ Ethiopis Tafara & Robert J. Peterson, “A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework” (2007) 48 Harv. Int’l L. J. 31 at 32.

¹⁸⁸ *Ibid.*

¹⁸⁹ *Ibid.* Generally, foreign exchanges and broker-dealers must register and comply with SEC supervision. *Ibid.*

¹⁹⁰ *Ibid.*

¹⁹¹ *Ibid.* at 47-48; Greene, *supra* note 158 at 87. Currently, in order for U.S. investors to purchase foreign securities, they must go through two-layers of broker-dealers; a domestic and a foreign layer. *Ibid.* at 48.

benefit of investors around the world.”¹⁹² The impact of such a system, however, would primarily be on retail and small or medium institutional investors. Large institutional investors, generally referred to as sophisticated investors, would not benefit as much, if at all, from such a system. Large institutional investors, who would qualify for QIB status under Rule 144A, have already established global outlooks and operations.¹⁹³

Because large institutional investors, or QIBs, already have efficient access to foreign securities through 144A and other rules, a system of substituted compliance would do little to increase investor access to foreign stocks. QIBs will have a substantial portion of security offerings, generally at the expense of smaller players. The increase in demand by retail investors will likely be nominal. Although the impact of small or medium institutions will be much larger, such institutions could be granted access by adjusting the definition of QIBs under Rule 144A. As a result, the existence of Rule 144A undermines the SEC proposal of a substantial compliance system.

The SEC is clearly interested in the convergence of certain elements of security regulatory systems.¹⁹⁴ The current progression of International Financial Reporting Standards (“IFRS”)/International Accounting Standards under the International Accounting Standards Board (“IASB”) is creating a real possibility that the U.S. may join with other jurisdictions, particularly Europe, to adopt a single set of accounting standards. The SEC has historically supported “convergence” of national regulatory standards,” including enforcement.¹⁹⁵ The SEC Office of International Affairs, the International Organization of Securities Commission (“IOSCO”), and other foreign jurisdictions continue to work together to establish and maintain high standards of security regulation and enforcement.

Unlike a system of substantial compliance, however, QIBs under Rule 144A are likely to benefit from continued regulatory convergence. Generally, non-U.S. issuers have been hesitant to enter U.S. markets because of heightened disclosure, accounting, and other regulatory standards, but such standards do not apply in a private placement transaction. Although the convergence of accounting standards will not change whether a QIB enters into a 144A transaction, it may streamline the process. Because QIBs have global operations, they must deal with the multitude of local accounting standards.¹⁹⁶ If the U.S. and other

¹⁹² Tafara & Peterson, *ibid.* at 33-34.

¹⁹³ *Ibid.* at 34.

¹⁹⁴ *Ibid.* at 49.

¹⁹⁵ *Ibid.* at 50. SEC promotion of convergence was traditionally done through “multilateral mechanism[s].” *Ibid.* at 55.

¹⁹⁶ It should be noted, however, that the European Union is now requiring public companies to adopt IFRS and other international accounting standards.

developed security markets adopt a single set of accounting standards, the transaction costs for QIBs will likely decrease by a significant amount. In addition, interaction between various branches of a global QIB will become faster and more efficient. Regional offices will be able to quickly understand the same set of data and interpret that data in a consistent manner. Further, convergence is likely to result in increased competition between markets, which could also lower transaction costs and raise the quality of financial services. Finally, increased convergence would also “eliminat[e] overlapping and duplicative requirements imposed by multiple regulators and discourag[e] regulatory arbitrage.”¹⁹⁷

As noted earlier, many commentators to the initial 144A proposal suggested that the SEC use a multi-stage approach that would first open the safe harbor to large institutional buyers and monitor the program to determine whether the rule should be extended to small or medium institutions.¹⁹⁸ When the SEC adopted the final version of Rule 144A, it stated that it “intends to monitor the evolution of this market and to revisit the Rule with a view to making any appropriate changes.”¹⁹⁹ According to its own release adopting Rule 144A, the SEC would periodically evaluate the 144A market and consider “the nature and number of regular participants in the market, the types of securities traded, the liquidity of the market, the extent of foreign issuer participation in the private market, and the effect of the Rule 144A market on the public market, and any perceived abuses of the safe harbor.”²⁰⁰

Re-evaluating Rule 144A does not mean the rule has to be rewritten or significantly altered. In fact, the SEC can fulfill its initial intentions by merely altering the definition of a QIB. Currently, an institution qualifies for 144A-QIB status only if it can pass the securities ownership test, which requires that financial institutions own \$100 million in non-affiliated securities. Banks must also have \$25 million in audited net worth. Broker-dealers have a separate standard. They must have an investment of \$10 million in non-affiliated securities.

By altering the securities ownership test, the SEC can take the next step in expanding the 144A market. The author proposes that the SEC consider lowering the security ownership test to \$75 million for financial institutions and banks. In addition, the required audited net worth of a bank could be reduced to \$22.5 million. For broker-dealers, the threshold amount could be lowered to \$7.5 million. By lowering each

¹⁹⁷ Susan Wolburgh Jenah, “Commentary on A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework” (2007) 48 Harv. Int’l L.J. 69 at 77.

¹⁹⁸ *Supra* notes 41-44 and accompanying text.

¹⁹⁹ “Resale of Restricted Securities”, *supra* note 41 at 8.

²⁰⁰ *Ibid.*

threshold amount by approximately 25%, the SEC can slowly open the 144A market to more institutions. Over time, the SEC can review the market and determine whether the current standards are sufficient, whether the rule should return to the previous thresholds, or whether more institutions should qualify for QIB status.

Regardless of the SEC final outcome, it is time that the SEC begins to reconsider extending Rule 144A to medium-sized institutions. The 144A market has experienced seventeen years of stable but exponential growth, suggesting that it is an appropriate step to optimality. In addition, the SEC should establish a medium-term plan to re-evaluate the 144A market in another five to ten years and determine whether the exemption should be further extended to small institutions and experienced retail investors.

VI. CONCLUSION

CONSISTENT WITH THE PRIMARY PURPOSE of the 1933 *Securities Act*, which was to protect unsophisticated investors from fraud, Rule 144A has relaxed some of the registration requirements in transactions between sophisticated buyers and sellers. The Rule 144A market is a complete success, especially for foreign issuers looking to gain faster and easier access to U.S. capital. Today, the 144A market is a liquid market for restricted securities that is second only to the public market. Both small and institutional investors have benefited from the market, but the real winners are foreign issuers.

Rule 144A is a “response to the unprecedented globalization of the world’s commercial securities markets [...] and] has proved popular among foreign companies who did not want to deal with the registration and reporting requirements associated with both making a public offering via the 1933 [Securities] Act and listing on a U.S. exchange.”²⁰¹ The *Sarbanes-Oxley Act* broke the SEC trend, which had been accommodating foreign issuers by granting exemptions.²⁰² The international business community reacted in a hostile manner—as predicted—but the *Sarbanes-Oxley Act* has made the 144A market an increasingly attractive alternative.

As liberal globalization²⁰³ continues, the Rule 144A market will continue to grow. In fact, recent changes in securities regulation—in

²⁰¹ Kenji Taneda, “Sarbanes-Oxley, Foreign Issuers and United States Securities Regulation” (2003) Colum. Bus. L. Rev. 715 at 726-27.

²⁰² *Ibid.* at 716.

²⁰³ Rule 144A liberalizes private placement rules in the United States and makes “it easier for foreign companies to issue securities in U.S. markets.” Scott, *supra* note 19 at 72.

particular those imposed by the *Sarbanes-Oxley Act*, which does not apply to the 144A market—are likely to cause the 144A market to grow exponentially. With the heightened registration and reporting requirements of *Sarbanes-Oxley*, the 144A market will become more efficient and profitable to foreign issuers. More and more foreign issuers will find that “when billion-dollar securities offerings can be completed without SEC registration to U.S. institutional investors who are willing to accept the issuer’s home market as the trading venue, foreign issuers are [going to be] less willing to incur the costs of SEC registration and U.S. listing.”²⁰⁴ In addition, the number of domestic issuers who contemporaneously seek to enter the public market—while conducting business in the 144A market—is likely to decrease. The result will be continued growth of the 144A market.

This growth, however, should not be limited to the current list of QIBs. The SEC should re-evaluate Rule 144A and its market to determine if the institutions qualifying for QIB status should be increased. The SEC could do so by lowering the threshold amounts necessary to qualify for QIB status. Regardless, it is time to begin a dialogue between the SEC and other market participants regarding the future of Rule 144A.

²⁰⁴ DeLaMater, *supra* note 7 at 117-18.