A big surprise

New private securities markets could make New York fashionable again

Over the past few years, the attraction of US public capital markets for non-US securities issuers has plummeted. This has largely been the result of a confluence of events: the passage of the Sarbanes-Oxley Act in the US, the growth of London’s Aim market during the otherwise lean post-9/11 years, and the developing maturity of local capital markets around the world. Some think that the US has lost its attraction for non-US issuers forever.

But that attraction could return faster and more strongly than many overseas stock markets, market participants and observers realise. It will probably not return as the result of US tinkering with Sarbanes-Oxley, or even through a wholesale gutting or repeal of that law. It may not return as a result of SEC efforts to coax back foreign issuers; these include the Commission’s steps toward the acceptance of International Financial Reporting Standards and its plans to make it easier for non-US broker-dealers to operate in the US trading markets. Yet a third development is underway that could generate a new attraction for non-US issuers. This is the emergence of special trading platforms in the US, for what US securities laws describe as restricted securities – equity (and also debt) securities that are issued, held and traded privately in the US.

Typically, when restricted securities are issued in any volume in the US, they are sold to investors under Rule 144A of the US Securities Act of 1933. Under Rule 144A, eligible buyers are restricted to qualified institutional buyers, or QIBs. QIBs are institutions managing investment portfolios of $100 million or more. In general, restricted securities remain restricted for two years from their issuance, although the SEC may soon shorten that period to one year. During that time they can be resold only to other QIBs, or if additional exemptions from SEC registration are available.

Despite the difficulty of reselling Rule 144A securities to non-QIBs, and the length of time that securities sold under Rule 144A stay restricted, the market for private offerings under Rule 144A has been a robust one, even for non-US issuers. This is the result of a number of factors. For one, the US has thousands of QIBs. The capital pool that issuers can tap using Rule 144A is immense. The QIB market is so big that issuers and their underwriting banks market Rule 144A offerings to them by conducting roadshows and handing out lengthy prospectuses, as if QIBs constituted their own mini-public. Also, the regulations governing how to conduct a Rule 144A offering are refreshingly brief. But the real attraction for non-US issuers is that, by selling their securities to US investors under Rule 144A rather than publicly, they avoid subjecting themselves to Sarbanes-Oxley. Moreover, they avoid many other US public offering requirements, which have been traditionally troublesome, time-consuming and expensive for non-US issuers – for example, they do not have to reconcile their financial statements to US Generally Accepted Accounting Principles (Gaap). Rule 144A offers issuers a way into US capital markets without the regulatory burden which a US public offering presents.

Rule 144A has provided one of the few remaining bridges between the US capital markets and non-US issuers during the lean years of the foreign-issuer exodus from the US public capital markets. Both before and after Sarbanes-Oxley and the other recent disincentives to going public in the US, non-US issuers have continued to make use of Rule 144A in a regular, active and fairly standard manner: conducting a public offering in their home jurisdiction, employing at least one underwriting investment bank with a strong US franchise, and selling a substantial minority of their new issue of securities privately into the US, to QIBs.

Easier trading

The good news for the US capital markets is that the level of attraction for non-US issuers, which the Rule 144A market generates, may be about to increase, and possibly by a large amount. What would lead to an increased level of attraction? One drawback that Rule 144A securities have presented for QIBs is that there has not been anywhere convenient for QIBs to trade their securities to other eligible investors, following the initial purchase of the securities in the original offering. Historically, if a QIB wanted to reduce or increase its position in a restricted security, it might go back to the original US underwriting bank and ask if the bank knew of any interested buyers or sellers. This never provided the QIB with an assurance of liquidity and never gave the QIB a way to assess the likelihood of potential future liquidity when deciding whether to buy the securities in the first place.

This has begun to change. A number of market participants have initiated, or announced plans to initiate, new trading markets for restricted securities. These include securities sold under Rule 144A. The establishment of such markets makes good business sense in an era of hedge funds and other non-traditional institutional investors that often want the capacity to trade all sorts of assets quickly and with minimum fuss. The first new trading platforms for Rule 144A securities include the Goldman Sachs Tradable Unregistered Equity System (GSTrue) and the Open Platform for Unregistered Securities (Opus-5), launched by a

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How to trade 144A
In contrast with these new trading systems, conventional trading platforms in the US and elsewhere, including public stock exchanges and national and international settlement and clearing houses, cannot readily offer aftermarket trading in Rule 144A and other restricted securities. This is because conventional trading platforms do not have the ability to identify both the seller of a particular security and the buyer down to the level of individual beneficial interest that SEC rules governing the trading of restricted securities require. Without such identification, it can be impossible to trade restricted securities without risking a violation of SEC rules. The new systems offer what the old systems did not: the opportunity to extend modern trading capabilities to legally permitted buyers and sellers only, excluding legally prohibited buyers and sellers. As long as these systems can filter individual buyers and sellers successfully, they can offer trading on a basis that complies with the SEC’s restricted securities rules. At the same time, they can provide the benefits of a real trading market: transparency, liquidity, speed of execution and a basis on which investors may predict future trading opportunities.

It is obvious what may follow: better trading opportunities, more trading and, if the underlying products are good, better valuations and higher prices. This in turn should make Rule 144A offerings more attractive to non-US issuers. It should increase the flow of non-US securities into the US through an established, and now improving, conduit.

Better than Aim
Beyond increased liquidity, there is even more good news for the US capital markets. If the Rule 144A market can achieve sufficient liquidity, it could compete strongly with Aim, the London equity market that presents non-US issuers with one of the more compelling alternatives to a public offer of securities in the US. Aim sells itself as a market regulated on a light-touch basis. The offer, sale and resale of Rule 144A securities is even more lightly regulated, a point that is sure to surprise many non-US market participants. For all the talk of light-touch regulation in London, banks and lawyers insist on a large amount of accounting and legal work to obtain a listing. This is in part due to Aim rules but also to London market conventions. For example, in a Rule 144A offering, accountants must help prepare the financial statements for publication and provide comfort letters. In an Aim transaction, they must do these things, and produce a long-form report, which gives an assessment of the general financial and business position of the issuer; they must also produce a working capital report, which outlines their assessment of the working capital position of the issuer going forward. It is clear that an issuer can easily spend as much time and money on accounting and legal compliance in an Aim listing as it can in a Rule 144A offering. They may even spend more. Aftermarket reporting on Aim is also more rule-bound than it is under Rule 144A. If an issuer considers the burdens of both the initial offering and ongoing reporting, a liquid Rule 144A market may look much more attractive than Aim, as well as many other non-US listing alternatives. A liquid Rule 144A market could give Aim and other such institutions a serious run for their money.

There are two reasons why a newly liquid Rule 144A market may still fail to bring the world back to the US capital markets. First, SEC rules require that any company whose securities are held by 500 or more persons in the US must become a public reporting company in the US. This would mean becoming subject to Sarbanes-Oxley, regularly reconciling financial statements to US Gaap, and meeting ongoing reporting requirements under rigorous disclosure standards. But if the company is non-US, the SEC allows it to apply for an exemption from reporting company status (under Exchange Act Rule 12g3-2(b)) while its US investor base is still small. As long as a non-US company can secure this exemption before it acquires too many US investors, it should be able to save itself from US public reporting company status. Interestingly, the Rule 12g3-2(b) exemption is not available to US companies. However, SEC rules permit US companies to count their shareholders differently from non-US companies. They therefore have other opportunities for avoiding US public reporting company status.

Second, the SEC will always retain the authority to increase the level of regulation applicable to the Rule 144A market. The SEC could conceivably opt for heavier regulation of the market as it grows. But it would risk killing a goose that had begun to lay golden eggs. If the new restricted securities trading markets come into their own as liquid trading venues, the SEC must keep in mind the original rationale behind Rule 144A: that the sale of securities to QIBs can be very lightly regulated. Within the context of the general US securities rules that prohibit issuers and other sales participants from deceiving investors, QIBs are big enough to take care of themselves.

If that remains the guiding principle of Rule 144A regulation, including in the context of the developing restricted securities trading platforms, then a strong liquid trading market in Rule 144A securities could indeed develop. Such a market would provide broad and deep capital pools, and regulation so light it would actually be lighter than Aim. The combination of these elements should have non-US investors lining up to sell their securities privately into the US capital markets as never before. Non-US securities markets have benefited from the fact that US public offerings were out-of-fashion. They could be in for a big surprise. The US may storm back as a global capital market of choice, for reasons which non-US market participants do not yet seem to have considered.

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