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Private Security Placements and Resales to the Public Under SEC Rule 144

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PRIVATE SECURITY PLACEMENTS AND RESALES TO THE PUBLIC UNDER SEC RULE 144

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The sale of securities by firms without registering the security with the Securities and Exchange Commission (SEC) has been allowed through the SEC's Rule 144 since 1972. The private placement market is a large and growing market with 2,709 private placements raising over $197 billion in 1996. The capital raised in this one year is nearly one-third of the dollar amount raised over the four-and-a-half-year period of January 1, 1990, through June 30, 1994, where 11,555 issues raised $586 billion.

REASONS FOR THE PRIVATE PLACEMENT MARKET'S POPULARITY

The private placement market is a popular place for companies to raise capital for several reasons. To raise capital in the public financial markets the security must be registered with the SEC, and an underwriter is typically hired. The costs associated with the underwriting of a security for the purpose of selling it to the investing public are influenced by the legal liability associated with being an underwriter. These costs are, in turn, charged to the company issuing the security.

According to the SEC's Release 33-7391 of February 20, 1997,

> The statutory definition of underwriter does not provide a means to determine objectively whether a person purchased securities from the issuer or an affiliate with a view to distribution of the securities... (The term) underwriter (is defined as) any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.

Rule 144 was adopted as a non-exclusive safe harbor to set forth objective criteria that could

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EXECUTIVE SUMMARY

- *This article summarizes the reasons for the popularity of using the private placement market to raise capital, and describes the composition of the private placement market in terms of the types of securities issued and the dollar amounts raised. The typical security issued is debt for an average and median amount of $51 and $24, respectively. Common equity issues are also small, with average and median amounts of $53 and $17 million, respectively.*
- *A description covers the types of securities actually resold into the public financial markets. Predominantly only common equity is resold to the public and the majority of that common equity is issued by small companies with a market value of equity of less than $200 million.*
- *Rule 144 places restrictions on investors who purchase these privately placed securities and want to resell them to the general public, including restrictions on hedging the restricted securities when informed investors anticipate underperformance, and constraints on resale of the securities into the public financial markets. Also included are questions relating to these restrictions that were posed by the SEC in its February 20, 1997 Rule 144 proposal release number 33-7391.*

be relied on by persons who wanted to resell restricted or control securities, but who were concerned whether they could be deemed to be engaged in a distribution, and therefore deemed to be underwriters.

Raising capital in the private placement market requires neither an underwriter nor registration of the security with the SEC. Qualified investors, as defined by the SEC, are the primary purchasers of privately placed securities. Financial economists argue that qualified investors are sophisticated enough to demand sufficient information to correctly price the security. In addition, the company selling the security has an incentive to provide information to reduce the required return on the security demanded by the purchaser. There are costs associated with a private placement that are not present in a registered underwritten issue. The foremost is that the privately placed security is less liquid than a publicly traded one. Additional costs imposed on the private placement market have included restrictions on the resale of these securities among qualified investors, restrictions on hedging the restricted security when informed investors anticipate underperformance, and the constrained resale of the securities into the public financial markets.

In deciding whether to raise capital in the private versus public markets the costs and benefits of each alternative must be weighed. Some of the costs of registration and underwriting are fixed costs. There are, therefore, economies of scale in the raising of funds. On a per-dollar-raised basis, the cost of funds thus declines with the size of the issue. A company must trade off the cost of raising a large amount of capital periodically and using that capital over time versus the costs of raising smaller amounts of capital more frequently in the private placement market when capital is needed.

There are costs associated with a private placement that are not present in a registered underwritten issue

The size of the issue and the costs of registering and underwriting it explain the popularity of private placements. Another reason for their popularity is the variety of securities that can be issued. There are costs to understanding the features of a security and pricing it. The investing public, which does not tend to purchase securities in large amounts, finds it costly to go through this pricing process if the security is complex. Sophisticated institutional investors that do hold large amounts of a security find, however, that it is less costly to value the security, and will pay a higher price than the general public. This is one of the reasons that publicly issued corporate securities are simple securities relative to many that are issued in the private placement market. In addition, it is less costly to renegotiate the terms of a privately placed issue giving more flexibility to both the company issuing the security and the institutions purchasing it.

PRIVATE PLACEMENT MARKET AND RULE 144 RESALE RESTRICTIONS

Companies that use the private placement market typically sell debt securities. Debt securities account for 87 percent of private placement issues and 85 percent of the dollar amount of funds raised in private placements. Convertible debt, preferred equity, and convertible preferred equity constitute less than 5 percent each of the private placement market both in terms of the number of issues and the dollar amount raised. Common equity issues are 8 percent of the number of issues and 9 percent of the total dollars raised through Rule 144. Of all private placements, 81 percent of the number of issues and 79 percent of the dollars are raised by U.S. companies, while the remaining percentages are foreign companies raising capital in the U.S. private placement market. The average debt private placement is $51 million with a median of $24 million. The average equity private placement is $53 million with a median of $17 million. The relatively small amount of capital raised in a given issue is consistent with the private placement market providing a lower cost of capital for companies needing a smaller amount of capital. At these small amounts, the registration and underwriter fees would be a substantial proportion of the capital raised.

Companies may issue either fungible or non-fungible securities. Fungible securities correspond to an identical security currently trading on a U.S. public exchange. As of April 30, 1990, Rule 144A was adopted and non-fungible securities became eligible to be traded by qualified institutional buyers (QIBs). This increased the potential liquidity of privately placed securities. Illiquidity increases the required return demanded by the purchaser of the securities. The increased liquidity under Rule 144A should

reduce the required return thereby reducing the cost of capital to the company raising capital.

Under Rule 144A, debt is eligible for resale in one-third of the placements made by U.S. companies. Equity placements are immediately eligible for trading for only 2.1 percent of the equity placements because most of the companies issuing equity already have the same equity security listed on a U.S. exchange. Equity placements by foreign issuers account for 33 percent of the total equity placements in the United States, with more than half eligible for immediate trading by QIBs.

Under the Rule 144 release of April 30, 1990, securities are not allowed to be resold for two years from the time they are sold by the company to an investor unless they are non-fungible and thus qualify under Rule 144A for immediate reselling among QIBs. Between two and three years after the original sale of the security, it can be sold to the general public subject to certain restrictions. If the holder of the security is an affiliate of the company, the securityholder must continue to meet the restrictions on reselling to the public even after three years. For non-affiliated holders, all restrictions on reselling the security are lifted after holding the security for three years. The company that originally sold the security must, however, be a reporting company under the 1934 Securities Act in order for either a non-affiliate or affiliate to sell it to the public. On February 20, 1997, the SEC adopted a release shortening the holding periods from two and three years to one and two years, respectively. It became effective April 29, 1997, and was applicable to all privately placed securities whether placed before or after the adoption of the release.

In deciding whether to raise capital in the private versus public markets the costs and benefits of each alternative must be weighed.

Rule 144 has a manner-of-sale restriction that requires a sale to the public to be made through a broker. Moreover, if 500 or more shares or more than $10,000 worth of the security is intended to be resold to the public, a Form 144 Filing with the SEC is required. Subsequent to the expiration of the holding period restrictions, there remain limitations on reselling a privately placed security to the public to prevent shocks to the public market for that security. These limitations are based on typical trading volume in the security and shares outstanding, respectively. For the volume restriction, the resale limit is defined by the average weekly reported volume of trading in the identical security on all national exchanges during the previous four calendar weeks preceding the sale, or the average weekly reported volume on the consolidated transactions reporting system during the previous four-week calendar period. The percentage of shares outstanding limitation restricts resales to the maximum of 1 percent of that security outstanding at the time of the intended sale. If a security is not currently traded on any domestic exchange, 1 percent of the security's original issue amount can be sold to the public. The higher of the volume and percentage of shares outstanding limitations provide the maximum amount that an investor can sell to the public during a three-month calendar period prior to the filing date of the Form 144 filing made with the SEC indicating the intent to sell the security to the public.

Prior to April 30, 1990, a privately held security could not be hedged without stopping the clock on the required holding period. Subsequent to this date, hedging against losses in the security would not result in a lengthening of the holding period. Tolling provisions relate to how long the security has been held relative to the time restriction. Prior to April 30, 1990, whenever the security was hedged (e.g., through a short sale of that same security or the purchase of a put on that security), the clock stopped running or the security was tolled. Subsequent to April 30, 1990, hedging the security did not toll it. Further, under Rule 144A the time period is determined from the original issue date and reselling it among QIBs does not toll the security.

PRIVATE PLACEMENTS REACHING THE PUBLIC FINANCIAL MARKETS

Securities sold in the private placement market are primarily debt, but most of the securities that ultimately reach the public financial markets are equity. Over the period of January 1, 1988, through April 30, 1996, 218,124 Form 144s were filed with the SEC. While only 8 percent of the security placements made in the private placement market are equity, 97 percent of the 144 forms filed with the SEC (211,339 out of 218,124) are for common equity to be resold to

the public. There are only 400 filings for the resale of debt.

For individual Form 144 filings, the average amount is less than 1 percent of the shares outstanding, consistent with the Rule 144 percentage of shares outstanding resale restriction. This limitation prohibiting resale of more than 1 percent of the security outstanding over a three-calendar-month period is a binding constraint for only 7.7 percent of the filings. The lower the total market value of the company's equity, the more frequently investors exceed the 1 percent limit. For companies with an equity value of less than $25 million, 11.6 percent of the resales exceed the 1 percent of shares outstanding test. Once market capitalization is in excess of $400 million, less than 5 percent of the filings exceed the 1 percent of shares outstanding restriction and this percentage generally continues to decline as company size increases. When examining the volume restrictions, results similar to the 1 percent outstanding test are found. For companies with an equity value less than $25 million, 12.2 percent of the resales exceed the volume test. For companies with an equity value between $25 and $100 million, 6.6 percent of the resales exceed the volume test. For companies larger than $100 million, resales that exceed the volume test are less than 4 percent and generally decline as company size increases. A resale in excess of the shares outstanding test or the volume test is permitted as long as both of the tests are not exceeded. Investors in smaller companies run up against the Rule 144 resale limitations more frequently, consistent with their fewer securities outstanding and lower trading volume.

Smaller companies are likely to find the private placement market a cost-effective method for raising equity.

Exhibit 1 presents descriptive statistics on the resale of common equity into the public markets obtained from Form 144 filings. The mean and median number of shares sold is 42,186 and 10,000, respectively. The average dollar value of the sale is almost $400,000 and the lowest median is $36,000. Almost all resales of equity are therefore above the 500 share or $10,000 level requiring a Form 144 filing. The dollar value sold increases with the size of the company, while the number of shares sold in a filing generally decreases consistent with the lower share prices of smaller companies.

Resales of privately placed common equity increased shares outstanding of issuing companies by an average of 11.28 percent over the period from January 1, 1988, through April 30, 1996. The mean varies across company size categories, from a minimum of 2.45 percent for companies with an equity value between $1,500 and $2,000 million to a maximum of 32.43 percent for companies with an equity value between $300 and $400 million. The median increase in shares outstanding never exceeds 2.5 percent, suggesting that the high means observed for some company size categories are driven by a few companies with large increases in shares outstanding.

Exhibit 1 shows that the use of Rule 144 to raise capital through equity is primarily a small company phenomenon. The number of filings is highest for companies with equity valued at less than $25 million. This group has 84,242 out of 211,338 filings with a median number of shares sold of 10,000 for a market value of $36,000 per filing. The cumulative effect for the typical company over the four-and-a-half-year period is a mean (median) increase of 13.84 percent (2.5%) in common equity trading in the financial markets. The number of different companies that had equity resold under Rule 144 in this size group was 4,678 out of a total of 10,111 companies. The next largest number of companies were 2,390 having equity capitalization values of between $25 and $100 million. The majority of the filings are for companies with equity values of less than $200 million. This fact is not a coincidence. The only alternatives to the private placement market are shelf registration or a full registration with the SEC. The ability to issue securities using shelf registration depends on the market value of a company's equity that is held by unaffiliated investors. Prior to April 30, 1990, companies with less than $150 million in float were not eligible for shelf registration. Subsequent to April 30, 1990, this limitation was lowered to $75 million in float. With a choice between private placement and a fully registered security issue, smaller companies are likely to find the private placement market a cost-effective method for raising equity.

REVISITING RULE 144A RESTRICTIONS

On February 20, 1997, the SEC issued release 33-7391 in which revisions of Rule 144, Rule 145,

EXHIBIT 1

Statistics on the Resale of Common Equity into the Public Markets Obtained from Form 144 Filings

Market capitalization of firms before resale (in millions of $s)	Number of shares sold			Dollar value of shares sold			Percent of shares outstanding sold per 144 filing			Percent increase in shares outstanding		
	Number of Resales	Mean	Median	Number of Resales	Mean	Median	Number of Resales	Mean	Median	Number of Companies	Mean	Median
$0-$25	84,242	54,147	10,000	82,901	186,917	$36,000	70,185	0.93	0.14	4,678	13.84	2.50
$25-$100	47,342	30,032	10,000	45,825	260,479	$80,000	45,009	0.40	0.10	2,390	7.60	2.09
$100-$200	26,839	24,177	8,126	26,077	$393,245	$120,000	25,809	0.44	0.06	2,026	11.14	1.84
$200-$300	13,754	21,130	7,025	13,337	$481,455	$150,000	13,173	0.42	0.04	499	11.11	1.12
$300-$400	8,953	26,106	7,072	8,558	$561,353	$153,241	8,497	1.11	0.03	291	32.43	1.10
$400-$500	7,577	24,663	7,064	7,383	$675,697	$196,000	7,304	0.23	0.03	190	8.79	1.17
$500-$600	2,999	27,247	7,032	2,852	$576,328	$178,192	2,792	0.10	0.03	116	2.50	1.02
$600-750	3,323	36,177	10,000	3,161	$895,738	$233,000	3,133	0.24	0.03	167	4.47	0.70
$750-$1,000	4,916	24,376	8,000	4,686	$776,093	$205,006	4,645	0.09	0.02	156	2.57	0.52
$1,000-$1,500	4,054	28,281	8,250	3,886	$873,034	$245,938	3,856	0.11	0.02	165	2.64	0.41
$1,500-$2,000	2,835	26,984	6,000	2,615	$848,370	$212,584	2,594	0.09	0.01	97	2.45	0.24
greater than $2,000	10,452	36,097	7,017	9,996	$1,602,593	$330,000	9,915	0.11	0.01	346	3.29	0.20
Total	211,338	42,186	10,000	211,332	395,790	78,488	197,898	0.58	0.07	10,111	11.28	1.88

and Form 144 were proposed and open for public comment. The issues referred to in this section relate to the resale restrictions and filing of Form 144 mentioned in the release. The elimination of the manner-of-sale requirement is mentioned. This would allow for reselling these securities via the Internet. The threshold requirements for filing a Form 144 may increase to 1,000 shares or $40,000, although questions are raised regarding whether higher limits would be more appropriate. Elimination of the two trading volume tests is being considered such that all sellers would rely on the 1 percent of securities outstanding test.

The release also solicits comment on whether the Rule 144 holding period should be shortened from one year to six months. In conjunction with this reduction in the holding period, comment is solicited on whether the amount of securities that could be resold in any three-month period after completion of the holding period should be further reduced and/or if the volume restrictions are not removed whether the volume restrictions should be more restrictive. Comments are also requested on hedging. One question is whether or not hedging should be allowed, and if not allowed, for how long. Also, what would be the definition of hedging?

ENDNOTE

The author thanks Cathy Niden for helpful comments and suggestions. The Securities and Exchange Commission, as a matter of policy, disclaims any responsibility for any private publication or statements by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission, or the author's colleagues on the staff of the Commission. Please do not quote without author's permission. ■