

SEC Provides Relief on Private Placement Ruling

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In September 2020, the U.S. Securities and Exchange Commission released a No-Action Letter, which outlined their decision to apply Rule 15c2-11 to fixed income securities issued under Rule 144A. Historically, Rule 15c2-11 had not been applied to fixed income securities and was focused on equities that are traded over the counter (OTC). If implemented, this change in policy and enforcement may have detrimental consequences for issuers, broker dealers, and investors in securities issued under Rule 144A.

What are 144a Securities?

When a bond issuer offers a security to the investing public, the Securities Act of 1933 requires that the issuer register the bonds with the Securities and Exchange Commission (SEC). This process entails extensive documentation, review, and recurring disclosures. However, there is an exception for bonds issued under Rule 144A, which allows privately placed securities to be sold and traded to Qualified Institutional Buyers (QIBs) without SEC registration. QIBs are defined as institutions (not individuals), deemed to be an “accredited investor” under Rule 501 of the SEC’s Regulation D. To qualify as a QIB under Rule 144A, an insurance company must have a minimum of \$100 million in unaffiliated invested assets on a discretionary basis. The exception for QIBs is made because they are viewed as having more resources and access to information versus smaller institutions. As such, it is inferred that they can make sound investment decisions despite potentially having less information and ongoing required reporting provided by securities registered with the SEC.

What is Rule 15c2-11?

The U.S. Securities and Exchange Commission Rule 15c2-11 governs the publication of quotations by broker-dealers in a quotation medium other than a national securities exchange. It requires market makers to review basic issuer information prior to publishing quotations for that issuer’s securities. Market makers must have a reasonable basis for believing that the information is accurate and from reliable sources. The rule describes the kind of information that the broker-dealer must review and was originally adopted to address fraudulent behavior in the OTC market. Since its inception in 1971, Rule 15c2-11 has never been applied to or enforced in 144A issues and was not established with bond market structures in mind.

How Would the Application of this Rule Effect 144A Securities?

There are several ways this new interpretation will adversely impact the market for 144A securities. It would require private issuers to publicly disclose their financial information so broker dealers can provide quotes on the issuer’s bonds. This runs counter to the one of the benefits of issuing in the 144A market, which allows issuers to keep their financial information private for competitive reasons. Issuer information is already available to current and prospective holders of 144A securities. Rule 144A requires that holders and prospective buyers of those securities be given the right to obtain from the issuers’ financial information, upon request. If Rule 15c2-11 is applied to 144A securities, issuers would likely forgo issuing debt in the 144A market or use alternative means of financing at potentially higher costs. Issuers that decide against publicly disclosing their financials will reduce liquidity in the market for their existing and any future 144A securities. Under the new interpretation by the SEC, broker dealers will be required to gather, review, and confirm that the issuer’s information is publicly available in order to publish quotations for 144A securities. As a result, broker dealers may not make markets in 144A securities if these conditions can’t be met or it isn’t worth the effort and additional cost to do so. Investors will be impacted by a reduction in liquidity on outstanding 144A issues as quotes for some

fixed income securities may be harder to obtain and there could be a substantial decrease in dealer activity. Issuance in 144A securities would likely decline, which would reduce QIBs' opportunity set and other benefits of participating in the 144A market.

SEC's Plan for Implementation and Recent Notification of Relief

The new interpretation of the rule was in effect for fixed income securities immediately after the original No-Action Letter was published in September 2020. In response to requests from industry representatives, the SEC issued another No-Action Letter dated September 2021, which granted additional time for market participants to implement the operational and system changes necessary for compliance. A phased in schedule over three years beginning in January 2023 was established. However, on November 30th 2022, the SEC issued a revised No-Action Letter that provided a two year relief period to the 144A market from compliance with Rule 15c2-11, which expires in January 2025.

Conclusion

Bond market participants view the new application of Rule 15c2-11 to fixed income 144A securities as unnecessary and detrimental. The original purpose of Rule 15c2-11 was to protect retail investors from fraudulent behavior in the OTC equity market. Investors in 144A securities by law must be Qualified Institutional Investors (QIBs), which are inferred to be sophisticated and have the expertise to evaluate the risks associated with these issues. Financial industry groups and fixed income investors agree that transparency in the capital markets is paramount. However, the application of a rule meant for the equity markets to the fixed income markets without public notice and comment is inconsistent with long standing precedent and may have unintended adverse consequences. Industry groups will press to make the relief permanent and we'll keep you apprised of their progress.

Kevin Adams, CFA, is a Principal, Vice President and Senior Portfolio Manager at AAM with 27 years of investment experience. Kevin is responsible for constructing portfolios based on client-specific objectives, constraints, and risk preferences. He is also responsible for communicating market developments and portfolio updates to clients. Prior to joining AAM, Kevin worked as a Registered Representative for the National Business Association. He earned a BS in Corporate Communications from Northern Illinois University. Additionally, Kevin is a CFA Charterholder and a member of the CFA Society of Chicago.



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