Blogs
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Are There Still Such Things as Restricted Securities? —Part One

Rule 6-03(f) of Regulation S-X requires investment companies to make specific disclosures regarding any investments in "restricted securities," defined as "securities which cannot be offered for public sale without first being registered under the Securities Act of 1933 [the "1933 Act"]." The recently enacted Fixing America's Surface Transportation (FAST) Act expands the ability to sell unregistered securities. This poses the question of what impact the FAST Act may have on fund disclosures. Part One explains what S-X requires; Part Two will explain what funds do and how this might change as a result of the FAST Act. **What S-X Requires for Restricted Securities** Rule 6-03(f) requires investment companies to disclose their policies regarding the acquisition and valuation of restricted securities. Funds must also disclose any rights to demand registration of restricted securities. Note 6 to Rule 12-12 further requires funds to "Indicate by an appropriate symbol each issue of restricted securities," and include "the aggregate value of all restricted securities and the percentage which the aggregate value bears to net assets." Funds must also disclose, for each restricted security, its acquisition date, carrying value and cost. If a restricted security was acquired during the year, the disclosure must include "the carrying value … of unrestricted securities of the same issuer at: (1) The day the purchase price was agreed to; and (2) the day on which an enforceable right to acquire such securities was obtained …." **Impact of Rule 144A and Regulation S** In 1990, eight years after the adoption of Rule 6-03, the SEC adopted two regulations to facilitate resales of unregistered securities. The first, Rule 144A, allowed persons other than issuers to sell securities to "qualified institutional buyers" ("QIBs") without being treated as "underwriters" who would otherwise have to register the securities under the 1933 Act. Generally, QIBs are organizations (not individuals) that own or invest on a discretionary basis at least $100 million in securities of non-affiliates, which includes most mutual funds. The second, Regulation S, created a safe harbor for resales outside the U.S. that are not subject to registration under the 1933 Act. Although Regulation S covers a variety of transactions, the Rule 904 safe harbor for trades executed on a designated offshore securities market may be the most significant exemption for purposes of Rule 6-03. "Designated offshore securities markets" include most of the major securities markets outside the U.S. Under this rule, a mutual fund may resell a security in a designated offshore market even if the security is not registered under the 1933 Act. There are limits on the types of securities eligible for these exemptions. Unregistered securities of the same class as securities already listed on a U.S. securities exchange or dealer quotation system (such as PIPEs) cannot be resold under Rule 144A. Only securities traded on a designated offshore securities market may be resold under Rule 904. Although Rules 144A and 904 make it easier to resell unregistered securities, neither rule permits such securities to "be offered for public sale without first being registered" under the 1933 Act. Rule 144A(c) provides that a security sold in reliance on the rule "shall be deemed not to have been offered to the public." Preliminary Note 6 to Regulation S warns, "Securities acquired overseas, whether or not pursuant to Regulation S, may be resold in the United States only if they are registered under the [1933] Act or an exemption from registration is available." Thus, technically, an unregistered security eligible for resale under Rule 144A or Regulation S is still a restricted security as defined by Rule 6-03(f).

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