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Asset Management ADVocate

Are There Still Such Things as Restricted Securities?—Part Two

Funds Don't Identify Rule 144A and Regulation S Securities as "Restricted" Notwithstanding my technical interpretation of "restricted security" in Part One, my sampling of recent annual reports found no funds treating Rule 144A or Regulation S securities as restricted. The schedule of investments typically identifies Rule 144A and Regulation S securities with footnotes such as these:

> a This security may be resold to qualified institutional buyers under Rule 144A of the Securities Act of 1933. b This security may be resold to qualified foreign investors and foreign institutional buyers under Regulation S of the Securities Act of 1933.

Funds did not disclose policies regarding the acquisition and valuation of restricted securities unless they invested in securities not eligible for these resale exemptions. Some funds provided the aggregate amount of the Rule 144A securities; others do not. None of the annual reports I surveyed provided the security specific information required by Rule 12-12 for Rule 144A or Regulation S securities. This practice appears consistent with the SEC staff's interpretation of Rule 6-03. For example, in comments on a shareholder report, the staff advised that:

> If any … securities were obtained pursuant to SEC Rule 144A or are exempt from registration under section 4(2) of the Securities Act of 1933, please identify them as such and disclose whether the fund's board of trustees deemed the securities liquid. If the securities were not obtained pursuant to the exemptions noted above, additional disclosures are required pursuant to rule 6?03 of Regulation S-X.

In other words, so long as a Rule 144A or Regulation S security is liquid, it seems that a fund does not have to treat it as a restricted security as defined by Rule 6-03. **Impact of New Section 4(d)** The FAST Act exempts transactions meeting the requirements of new Section 4(d) of the 1933 Act. Section 4(d) permits resales of unregistered securities to "accredited investors" as defined in Regulation D. Accredited investors are defined more broadly than QIBs to include, among others, most institutions with more than $5 million in total assets (rather than the QIB standard of having $100 million in securities). Individuals may also qualify as accredited investors (but not as QIBs) based on their income or net worth. So, many more U.S. investors may now trade in unregistered securities. You will find a complete description of the other elements of the new 4(d) exemption here under the heading FAST Act Codifies Private Offering Exemption for Resales of Securities. Section 4(d) permits resales of any security of a class that has been outstanding for at least 90 days. This means that, once the 90-day waiting period expires, any unregistered security may be resold in compliance with Section 4(d). As was the case with Rule 144A and Regulation S, Section 4(d) does not permit securities to "be offered for public sale without first being registered." Section 4(e)(1) specifically provides that "Securities acquired in [a 4(d)] transaction shall be deemed to have been acquired in a transaction not involving any public offering." Hence, unregistered securities eligible for resale under Section 4(d) are still technically "restricted securities" under Rule 6-03. The staff's position, however, appears to be that an unregistered security does not have to be treated as restricted so long as it is determined to be liquid based on an exemption for registration under the 1933 Act and factors consistent with its being tradable. If the staff applies this position consistently to Section 4(d), then any

unregistered security for which there is a secondary market among accredited investors would not have to be classified as "restricted." The term "restricted security" will, in effect, be redefined as an "unregistered illiquid security." **Missed Opportunity** Last year, the SEC proposed amendments that would update investment company reporting regulations, including Articles 6 and 12 of Regulation S-X. The SEC also reopened the comment period for these amendments in connection with a proposal to regulate, among other things, investments in illiquid securities (including restricted securities). Neither proposal would make any changes to the definition of "restricted security" in Rule 6-03(f) to conform to the staff's current interpretation of the rule, nor would they modify the additional disclosures required by Rule 12-12. The SEC appears to have missed an opportunity to reconsider the objective of "restricted securities" disclosure and revise its rules in conformity with this objective.

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