

February 1993

SECURITIES REGULATION

SEC's Oversight of Privately Placed Transactions Among Large Investors



148516

■

General Government Division

B-246252

February 19, 1993

The Honorable John D. Dingell
Chairman, Committee on Energy and Commerce
House of Representatives

The Honorable Edward J. Markey
Chairman, Subcommittee on Telecommunications
and Finance
Committee on Energy and Commerce
House of Representatives

This report responds to your request that we review how the Securities and Exchange Commission (SEC) collected and analyzed data for its first two reports to you on the implementation of Rule 144A. SEC adopted Rule 144A in April 1990 to (1) increase the liquidity and efficiency of the secondary market¹ among large institutional U.S. investors for privately placed foreign and domestic securities that are not registered with SEC and (2) attract foreign securities to the U.S. capital markets. The rule allows large institutional U.S. investors to trade unregistered securities among themselves and eases disclosure requirements for foreign issuers of privately placed Rule 144A securities.

Because of concerns over possible adverse effects of the rule on U.S. investors, you asked SEC to report periodically on developments in the Rule 144A market. Your concerns included (1) the possible development of a two-tiered securities market for U.S. investors, one public and one private; (2) the greater likelihood that poor investments would be passed on to unwitting investors through mutual and pension funds or other avenues of leakage into the public markets; and (3) the rule's diminution of the amount and type of disclosure, particularly regarding foreign companies that issue 144A securities to U.S. investors. You asked SEC to respond to 13 overall questions. Some questions asked for factual information on who is purchasing Rule 144A securities, the number of foreign issuers, and other data on actual transactions. Others required SEC to assess such issues as whether the rule was achieving its intended goals and how it was affecting individual and institutional investors.

As agreed with the Committee, this report compares the data sources and methods SEC used to prepare its first and second reports. Also, as you requested, appendix II illustrates a Rule 144A equity offering by Robert Maxwell's Mirror Group Newspapers plc, and appendix III discusses the

¹The secondary market involves the buying and selling of securities after their original issuance.

extent of differences in U.S. and United Kingdom (U.K.) accounting standards. Although we did not attempt to evaluate SEC's responses to your questions or independently assess Rule 144A's effect on the marketplace, we did identify ways SEC could improve its data collection for future reports. Appendix I provides the details of our scope and methodology for meeting these objectives.

Results in Brief

SEC has issued two reports on the effects of this rule on U.S. markets and as of January 26, 1993, was preparing a third. SEC used multiple sources of data to monitor the Rule 144A market and prepare its first two reports. Collecting data for the reports was difficult because (1) the entire universe of Rule 144A transactions and market participants was unknown, (2) market participants were not required to report privately placed security transactions to SEC or any self-regulatory organization (SRO),² and (3) the market participants SEC contacted had differing views about the types of transactions that constitute Rule 144A placements.

The first report, dated February 12, 1991, covered 27 Rule 144A transactions³ totaling about \$2.7 billion. The data SEC collected on the 27 transactions were inconsistent in format and detail. SEC officials told us that the limited number of transactions and the details they had about those transactions were insufficient to answer many of your specific questions.

On the basis of experience gained with the first report, SEC refined its data collection method for the second report by clarifying and standardizing its questions of market participants. SEC also covered the marketplace better by expanding the number of participants contacted and including, for the first time, contacts with Rule 144A security issuers. The second report, dated September 30, 1991, covered 89 Rule 144A placements totaling about \$8.5 billion. The report contained substantially more data to support answers to your questions and began to identify trends and developments in the 144A market.

We identified two additional data sources that SEC could use to improve its coverage of the marketplace and to verify data from other sources. SEC officials agreed to use these additional sources of data in preparing their

²SROs, which include the securities exchanges and the National Association of Securities Dealers, are designated groups of industry professionals equipped with quasi-governmental powers to adopt and enforce standards of member conduct.

³The report listed 28 transactions, but 1 of the transactions did not include a U.S. placement.

future Rule 144A reports. They pointed out, however, that even with these additional data sources, SEC may not be able to cover the entire 144A market because reporting is voluntary and many participants may be reluctant to divulge their transactions.

Background

The Securities Act of 1933 requires that securities must be registered with SEC before they are distributed and that certain information regarding the securities and the issuer of the securities must be disclosed to prospective buyers. Rule 144A establishes a safe harbor exemption⁴ from the registration requirements of the 1933 act for resales of eligible privately placed domestic and foreign securities⁵ among qualified institutional buyers (QIB).⁶

Rule 144A was also meant to attract foreign issuers to the U.S. market. As part of the registration process under the 1933 act, U.S. and foreign companies must submit to SEC financial statements that meet U.S. accounting standards. A foreign company that privately offers Rule 144A eligible securities is not required to reconcile its financial statements to U.S. standards. A foreign company can comply with Rule 144A by registering under the Exchange Act or by periodically submitting to SEC all information it is required to disclose by its home country regulator. A foreign company that is neither registered with SEC nor furnishing home country disclosure materials must, upon a QIB's request, provide the QIB with a brief statement of the nature of its business and copies of its balance sheets and income statements for the preceding 2 years. To illustrate how the Rule 144A requirement could affect financial information disclosed to U.S. investors, appendix III discusses the extent of differences in U.S. and U.K. accounting standards.

⁴The safe harbor provides the assurance that registration under the 1933 act will not be required as long as the securities are sold within the rule's parameters.

⁵Eligible securities are securities that are not listed or similar to securities listed on a U.S. securities exchange or quoted on the National Association of Securities Dealers Automated Quotation System (NASDAQ).

⁶To qualify as a QIB, an investor must own and invest on a discretionary basis at least \$100 million in securities not affiliated with that QIB. Additional eligibility conditions apply to banks and savings and loan associations. Registered broker-dealers can qualify under the rule by owning and investing \$10 million in securities.

SEC Refined Its Data Collection Methodology After Its First Report

According to SEC officials, neither SEC nor any SRO requires market participants to report privately placed security transactions, including Rule 144A transactions. Consequently, SEC uses a number of sources to monitor the Rule 144A market and prepare its reports, including written and telephone surveys of market participants, articles in various financial market publications, and data obtained from the LEXIS/NEXIS⁷ database run by Mead Data Services and Investment Dealers Digest's Information Services (IDDIS) database of Rule 144A transactions.⁸

To compile data for its first report, SEC sent letters requesting information on Rule 144A transactions to 32 market participants. As shown in table 1, the participants included 19 broker-dealers, 10 QIBs, 2 debt rating agencies, and 1 SRO, the National Association of Securities Dealers (NASD). SEC officials said that in selecting the 32 market participants, they knew they might not cover all 144A transactions but they attempted to obtain data on as many as possible. These market participants were asked to report on initial issues and resales of securities they believed were eligible for trading under Rule 144A. However, SEC's letters contained no format for reporting data on the transactions, and SEC said that market participants had differing views on what constituted a Rule 144A security. Consequently, the 24 respondents provided SEC with information on 27 Rule 144A transactions in various formats and degrees of specificity. SEC said it did not have sufficient data to identify trends or otherwise analyze the data. However, SEC responded to your concerns by using the limited data obtained from market participants, supplemented by reviews of various articles and other databases. SEC reported that during the first few months, Rule 144A appeared to be attracting foreign companies to the U.S. capital markets and that there was no indication the rule had diverted securities offerings from public to private markets or that Rule 144A securities had leaked into the public markets.

⁷The NEXIS database covers over 600 national and international periodicals and news sources (including newswire services). This database also includes law reviews and scholarly journals. The LEXIS database contains text of court decisions from state and federal courts.

⁸IDDIS maintains a number of databases that track U.S. public offerings, U.S. private placements, and European offerings. These databases seek to identify every offering made in the various categories. IDDIS principally uses information obtained from broker-dealers and from publicly available sources in preparing its database.

Table 1: Market Participants Surveyed for the First SEC Report on Rule 144A

	Issuers	Broker-dealers	QIBs	Rating agencies	SROs	Total
Surveyed	0	19	10	2	1	32
Responses	0	11	10	2	1	24

Source: GAO analysis of SEC data.

On the basis of experience gained in the first report, SEC modified its survey of Rule 144A market participants for the second report. SEC added questions to its request letter and refined existing questions on the basis of the responses it received for the first report. SEC also added a questionnaire designed to collect information in a standard format.

Further, SEC expanded the number of participants surveyed. As shown in table 2, SEC added 72 market participants to its survey, including 51 securities issuers. Of the 104 market participants surveyed, 69 responded for the second report. SEC officials said that where responses were ambiguous or unclear, they sought clarifications of the information received from market participants by follow-up phone calls and comparison among different data sources.

Table 2: Market Participants Surveyed for the Second SEC Report on Rule 144A

	Issuers	Broker-dealers	QIBs	Rating agencies	SROs	Total
Surveyed	51	28	23	1	1	104
Responses	29	20	18	1	1	69

Source: GAO analysis of SEC data.

The more comprehensive and specific data collected during the second reporting effort enabled SEC to conduct various analyses that were not done for the first report, such as determining trends in the types of issuers, securities, and purchasers involved in the Rule 144A market. The additional data and new analyses of the data resulted in SEC providing more detailed information in the second report, such as providing more specific data on the various categories of purchasers.

SEC Agreed to Use Additional Data Sources

We identified and discussed with SEC officials two additional data sources that they agreed to use to further improve SEC's reporting on Rule 144A activities. These additional data sources will provide SEC another source of information to verify data on Rule 144A transactions collected from

market participants and expand its coverage of the Rule 144A market. The SEC officials agreed that these additional data sources will improve the accuracy and completeness of SEC's periodic reports on Rule 144A. An SEC official also said that SEC would still not be able to identify Rule 144A transactions known as direct sales between private parties, because the parties involved are not likely to voluntarily report the transactions to SEC.

One additional data source is Standard and Poor's (S&P) Committee on Uniform Security Identification Procedures (CUSIP) database, which is a standard method utilized throughout the financial community for identifying securities. When security issuers request an identification number and inform S&P that a security is eligible to trade under Rule 144A, S&P assigns a CUSIP number that identifies the security as Rule 144A eligible. An SEC official said that the unit within SEC that is responsible for reporting on Rule 144A was not aware that the CUSIP database specifically identified securities as eligible to trade under Rule 144A. In a later conversation, the official said that SEC had contacted S&P officials and arranged to use the CUSIP database for future reports on Rule 144A.

The second additional data source is maintained by the Depository Trust Company (DTC). Securities transactions between firms that participate with DTC, including Rule 144A transactions, may be settled by book-entry processing.⁹ DTC officials told us that SEC informally requested data concerning Rule 144A transactions cleared through DTC. However, SEC officials said that SEC used the data for other regulatory purposes, but not for either the first or second report on Rule 144A. SEC agreed that the existing DTC database would be useful for verifying book-entry Rule 144A transactions reported by other market participants and for monitoring book-entry transactions through DTC. SEC thus plans to use DTC's database for future reports.

Conclusions

Obtaining accurate and complete information on the Rule 144A market is difficult because of the nature of the market. The nonpublic characteristic that makes the private placement market appealing to large, sophisticated investors also makes it difficult for SEC to monitor market activity. Consequently, SEC uses a variety of data sources to monitor developments in the Rule 144A marketplace and to prepare the reports.

⁹Book-entry processing permits securities to be distributed quickly and economically through electronic delivery and settlement. Instead of transferring actual paper certificates, ownership is represented by entries in an investor's account at a bank, broker, or mutual fund, which periodically sends the investor a statement of the securities held in the account.

SEC's first effort to report on Rule 144A provided answers to your questions that were based on limited supporting data and analysis. Modifications and expansions to SEC's data collection procedures during the second reporting effort enabled SEC to collect and analyze more comprehensive and detailed data on the Rule 144A market. Although the private nature of the market might not allow SEC to identify all Rule 144A transactions, SEC officials have agreed to use two additional databases when preparing future reports. This should provide more complete data on Rule 144A transactions and enable SEC to better monitor and assess the impact of the Rule 144A market.

Agency Comments

SEC officials reviewed a draft of this report and generally agreed with the information presented. We have incorporated their clarifications and comments where appropriate.

We are providing copies of this report to SEC and other interested parties upon request. Major contributors to this report are listed in appendix IV. Please contact me at (202) 275-8678 or Larry D. Harrell, Assistant Director, at (202) 512-7310 if you have any questions concerning this report.



James L. Bothwell
Director, Financial Institutions
and Markets Issues

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Abbreviations

CUSIP	Committee on Uniform Security Identification Procedures
DTC	Depository Trust Company
QIB	Qualified Institutional Buyer
SBIL	Salomon Brothers International Limited
S&P	Standard and Poor's Corporation
SEC	Securities and Exchange Commission
SRO	Self-Regulatory Organization

Objectives, Scope, and Methodology

To obtain information on SEC's procedures used in collecting and analyzing data for periodic reports on the implementation of Rule 144A for the first and second reports, we (1) interviewed SEC officials responsible for reporting on Rule 144A; (2) collected data on the methodologies from SEC's Divisions of Corporation Finance, Market Regulation, and Investment Management; (3) reviewed letters and questionnaires these divisions sent to Rule 144A market participants and the responses they received for the first and second reports; and (4) compared SEC's responses in both reports to information obtained from Rule 144A market participants. We also discussed whether SEC was planning to modify its methodology for the third and future reports on the basis of its first and second oversight efforts.

We interviewed Rule 144A industry officials from the American Stock Exchange, Depository Trust Company, International Securities Clearing Corporation, National Association of Securities Dealers, New York Stock Exchange, Securities Industry Association, Goldman Sachs, Morgan Stanley, Salomon Brothers Inc., Standard and Poor's Corporation, and Moody's Investors Service to (1) determine how SEC obtained and verified data from Rule 144A market participants, (2) obtain market participants' views on the adequacy of SEC's data collection efforts and the Rule 144A market, and (3) identify ways SEC might improve its oversight reports on Rule 144A.

To address Rule 144A changes to disclosure requirements for foreign issuers participating in U.S. markets, we reviewed statutory and regulatory disclosure requirements before and after Rule 144A. We also discussed the requirements with SEC and industry officials.


To illustrate a Rule 144A offering, we collected and reviewed data from SEC, Salomon Brothers Inc., and available public documents on the late Robert Maxwell's Mirror Group Newspapers' Rule 144A offering. We reviewed how the Mirror Group's equity securities offering occurred from its issuance until the securities were sold to U.S. institutional investors.

To identify the extent of differences in U.S. and United Kingdom (U.K.) accounting standards, we reviewed documents prepared by SEC, Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, Price Waterhouse, and the American Institute of Certified Public Accountants that compared U.S. and U.K. accounting standards. We also reviewed offering circulars of four foreign firms to check whether differences in accounting standards were noted for the

financial information disclosed. We consulted with SEC on the significance of the differences in accounting standards.

We did our work in Washington, D.C., and New York City from October 1991 through October 1992 in accordance with generally accepted government auditing standards.

Illustrative Rule 144A Offering: Mirror Group Newspapers plc

SHARE  OFFER

Daily Record **SUNDAY mail** **THE PEOPLE** **The Sporting Life** **SUNDAY Mirror** **DAILY Mirror**

**MIRROR GROUP
NEWSPAPERS plc**

OFFER

**BY
SAMUEL MONTAGU
& CO. LIMITED**

This appendix uses the Mirror Group Newspapers plc offering to illustrate a Rule 144A offering that has occurred. We did not review other private placement offerings in detail and are not suggesting that this offering is typical of all Rule 144A transactions.

Mirror Group Newspapers plc, a publisher of national newspapers in Britain, used the U.S. private placement market and Rule 144A as a part of a global offering of ordinary shares.¹ Before the May 1991 offer, all the capital stock of the Mirror Group was owned by Robert Maxwell Holdings Limited, a company whose ultimate parent was Headington Investments Limited. The Mirror Group circular stated that it intended to raise capital from the distribution of securities to reduce the Group's bank loans and repay in full a loan that Mirror Group received from Robert Maxwell Holdings. After the distribution, Robert Maxwell Holdings was to own 51 percent of Mirror Group Newspapers' capital stock.

As illustrated in figure II.1, the combined offers involved 196,392,000 ordinary shares, par value 25 pence,² that were marketed by the issuer at 125 pence per share. The initial distribution of ordinary shares outside the United States was exempt from 1933 Securities Act registration requirements under SEC Regulation S.³ Samuel Montagu & Co. Limited, a British firm, was the underwriter⁴ for the public offering of 114,000,000 shares on the London Stock Exchange and 3,856,000 shares included in a Mirror Group employee share ownership trust. Salomon Brothers International Limited (SBIL), as the global coordinator, committed to purchase and arrange the overseas placing of 78,536,000 ordinary shares with institutional investors outside the United Kingdom. The Mirror Group's overseas placement was sold in several places: (1) a U.S. private placement under Rule 144A; (2) "the Canadian Placing", a private placement in Ontario and Quebec; and (3) "the international Placings,"

¹Ordinary shares is the British term for common stock.

²100 pence is equivalent to 1 British pound. According to Salomon Bros. Inc., during the time of issuance, a British pound was equivalent to about \$1.75.

³SEC adopted Regulation S in April 1990 (around the same time as Rule 144A). Regulation S provides that offers and sales outside the United States are not subject to the registration requirements of the Securities Act of 1933. It establishes criteria for determining (again on a "safe harbor" basis) that certain offers and sales are made outside of the United States. Under Regulation S, the Mirror Group's shares could not be offered or sold to a U.S. investor for 40 days after issued. However, during the 40-day period, the shares could have been resold to qualified institutional buyers pursuant to Rule 144A.

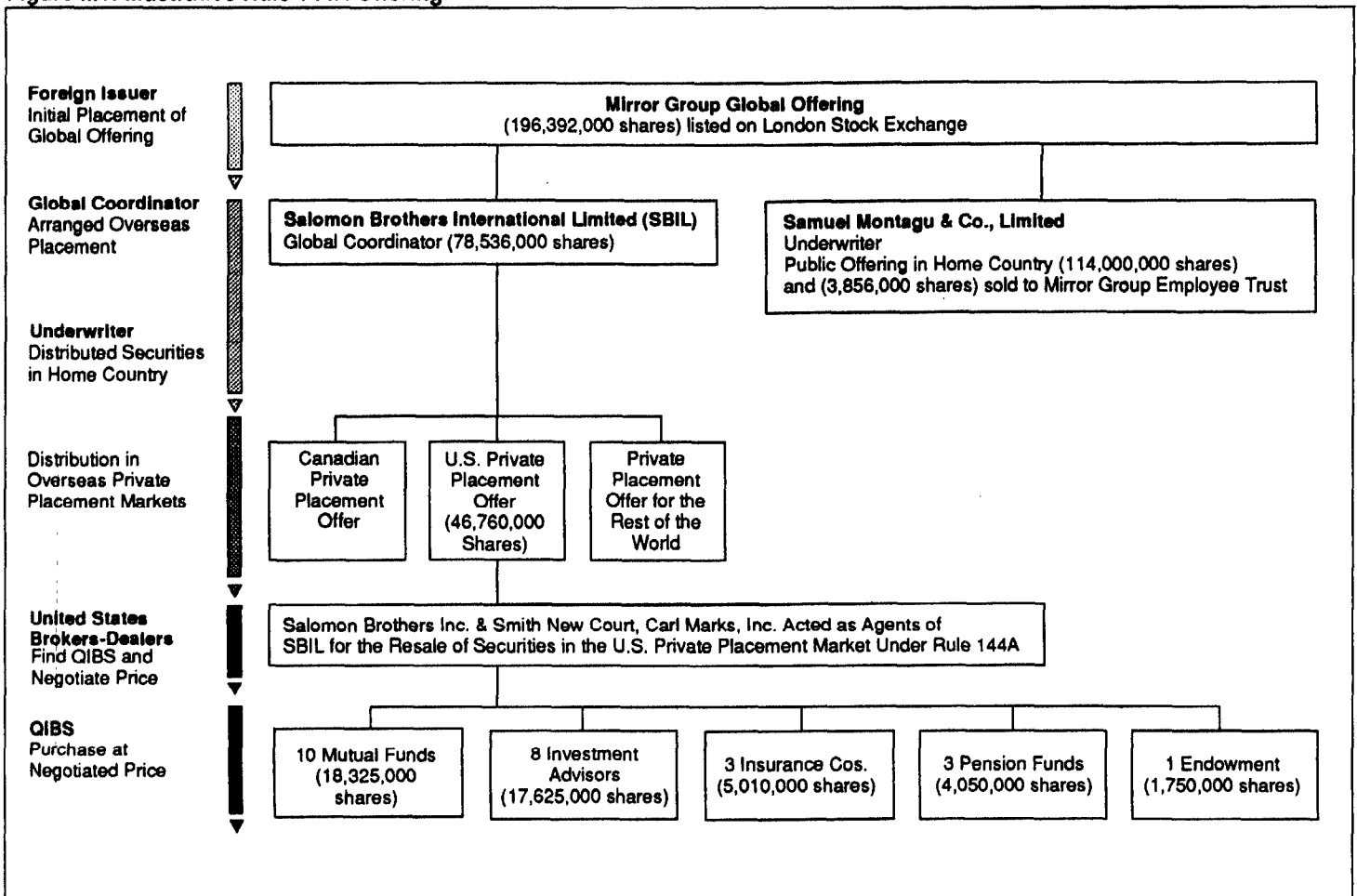
⁴As an underwriter, Samuel Montagu & Co. Limited assumed the risk of buying a new issue of securities from the issuer and reselling them to investors in a public offering.

**Appendix II
 Illustrative Rule 144A Offering: Mirror
 Group Newspapers plc**

private placements in Europe (excluding the United Kingdom) and the rest of the world.

As agents for SBIL in the United States, Salomon Brothers Inc. and Smith New Court, Carl Marks Inc., were responsible for finding and negotiating with qualified institutional buyers (QIB) for the purchase of the Mirror Group's Rule 144A shares. As shown in figure II.1, the QIBs purchasing the shares included 10 mutual funds, 8 investment advisors, 3 insurance companies, 3 pension funds, and 1 endowment.

Figure II.1: Illustrative Rule 144A Offering



Differences in U.S. and United Kingdom Accounting Standards

Differences in U.S. and United Kingdom (U.K.) accounting standards could affect how some financial information about British security issuers is disclosed. Based on our review of available comparative documentation, a number of differences affect how certain financial information is applied to business transactions and measured and disclosed in each country.¹ For example, an Ernst & Young comparison² cited 14 principal areas of differences and many specific differences that may affect how some financial information for U.K. issuers is measured and disclosed, such as accounting for mergers and acquisitions. Ernst & Young's comparison said that differences between U.S. and U.K. accounting standards may be broadly categorized into differences arising from measurement standards and disclosure standards, but the comparison also includes many differences between U.S. and U.K. financial reporting practices. For example, the Ernst & Young comparison said that formats for the balance sheet and profit and loss account (also known as the income statement) are quite different in each country, the terminology and technical terms used are often not uniform, and a number of financial statement items are classified differently.

An American Institute of Certified Public Accountants' comparison also discussed many differences in accounting practices and concluded that there are a number of significant areas covered by U.S. accounting standards that are not covered by U.K. accounting standards, such as various debt and revenue accounts.³ Documentation obtained from SEC showed that a large number of differences exist in the details of specific accounting standards and the methods of their implementation. For example, a review of U.K. standards by SEC staff showed that a greater level of flexibility is permitted for certain measurements and disclosures than is allowed by U.S. standards. According to an SEC official, whether or not an investor would consider any of the differences significant depends on the investor's interests and strategies.

To obtain a better understanding of the cost and complexity of compliance with U.S. accounting standards, SEC asked the Big Six accounting firms to survey and compare certain U.S. accounting standards and practices to

¹According to the Financial Times, U.K.'s Accounting Standards Board issued a new financial reporting standard on October 28, 1992, that requires U.K. companies to provide more information in their financial statements issued after June 22, 1993.

²UK/US GAAP Comparison: A Comparison Between UK and US Accounting Principles, Ernst & Young, London, September 1990.

³The Accounting Profession in the United Kingdom: Professional Accounting in Foreign Countries Series, 1987, American Institute of Certified Public Accountants, prepared by Arthur Andersen & Co.

**Appendix III
Differences in U.S. and United Kingdom
Accounting Standards**

certain other countries' standards and to International Accounting Standards.⁴ Among other findings, the survey showed that U.S. standards are relatively more complex in a number of areas than those in other countries. The survey also showed that significant differences in the accounting methods used in other countries may hamper comparative analysis. For example, the survey concluded that differences in accounting practices outside the United States, such as accounting for goodwill, result in significant differences in earnings and may create an unlevel playing field.

Industry officials provided four examples of offering circulars of foreign Rule 144A issues that were used to disclose financial information to U.S. investors. Three of the four circulars showed that even though they were not required to reconcile financial statements, the foreign issuers provided explanations of the areas of differences between U.S. and foreign accounting standards. For example, the circular for the Maxwell Mirror Group's Rule 144A offering included a section on general differences in U.S. and U.K. accounting standards and noted how certain financial information would have been accounted for under U.S. accounting principles. The circular, however, did not provide adjusted financial figures in accordance with U.S. standards. Among some of the differences in U.S. and U.K. accounting standards highlighted in the Mirror Group's circular were

- how pension plans were accounted for,
- how extraordinary items were interpreted, and
- how cash flow/income statements were presented.⁵

⁴Survey of International Accounting Practices, compiled by Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Price Waterhouse, 1991.

⁵According to an SEC official, recent developments in the United Kingdom have resulted in cash flow statements similar in many regards to U.S. cash flow statements. However, classification of certain items is still different.

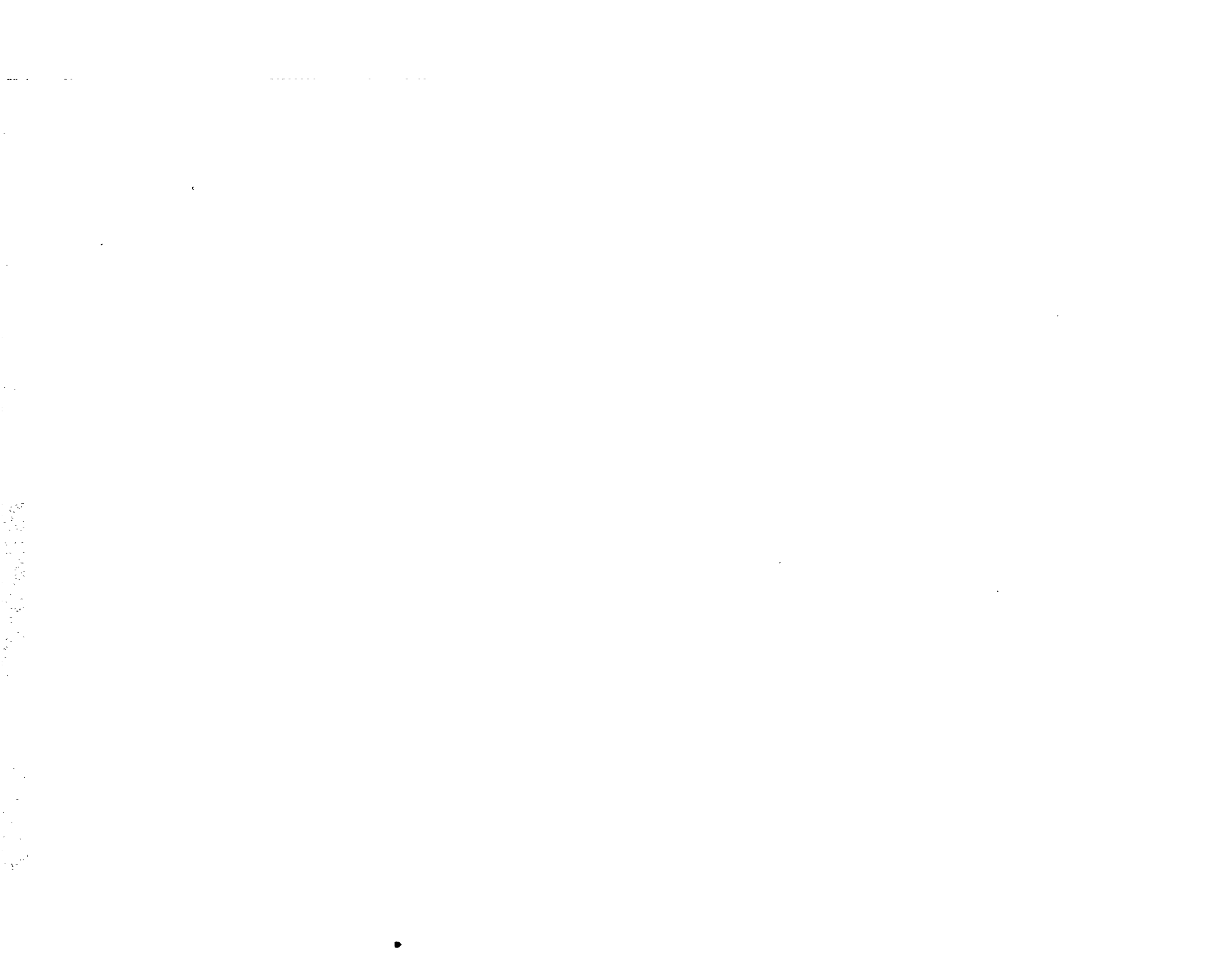
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