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Special Report

How Rule 144a May Shape Venture Capital

SEC Action Could Help Foster Young Companies

by Robert B. Mills and Charles A. DiLisio

Don't discount Rule 144a yet. Since its adoption by the Securities and Exchange Commission (SEC) last April 19, the much-heralded revision to U.S. securities law has fallen short of the initial expectations of the investment community and financial markets. But Rule 144a has significant implications, some immediate and others longer-term, for the venture capital industry and for emerging growth companies.

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In the near-term, Rule 144a could benefit early-stage venture capital investors by increasing their returns. It has the potential to adversely affect later-stage investors, whose returns could decline. At the same time, the measure could help young, emerging growth companies by allowing them to enjoy higher valuations and obtain more capital.

Longer term, the impact of Rule 144a could be even more sweeping, particularly if the SEC makes further revisions to the rule. Institutions could begin to dominate later-stage and bridge venture financing. The measure might prompt emerging growth companies to postpone initial public offerings until much later in their development. It could give corporations a new tool for spinning off subsidiaries. It might even give rise to an entirely new kind of venture capital fund, one that would invest exclusively in Rule 144a securities of both U.S. and foreign companies.

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Bundle of Joy

The SEC action actually involved several measures, which collectively have become known as "Rule 144a." The SEC approved Rule 144a and amended Rules 144 and 145. In addition, it cleared the way for the creation of PORTAL, a screen-based computer system designed to facilitate trading of Rule 144a securities.

These combined changes will make it easier for companies to sell, and institutions to trade, restricted securities, typically referred to as private placements. In a private placement, a company sells a block of equity or debt directly to an institutional investor, such as an insurance company, pension fund, or mutual fund.

The SEC's objectives in adopting Rule 144a were to:

- Increase liquidity through secondary trading of the private placements, and thereby reduce the issuers' cost of capital, and
- Attract foreign issuers that have historically avoided the highly regulated U.S. capital market, reinstating the U.S. as the preferred capital market.

This article outlines the key elements of Rule 144a, describes the current status of the Rule 144a securities market, and assesses the future impact Rule 144a could have on venture capital firms and emerging growth companies.

The Nuts & Bolts

Rule 144a allows the immediate resale of *eligible securities* to *qualified institutional buyers* (QIBs). Rule 144a requires that *certain issuer information* be made available to a prospective qualified institutional buyer prior to resale. In addition, the seller must take reasonable steps to ensure that the prospective buyer is a QIB.

Eligible securities of the issuer — whether the company is domestic or foreign, public or private — may not be of the same class with securities trading on a U.S. securities exchange or quoted on NASDAQ. Securities are of the same class if they are of substantially similar character as publicly traded securities, and if the holders enjoy substantially similar rights and privileges as holders of publicly traded securities.

Convertible securities are considered eligible securities if the conversion premium is at least 10%. Warrants are considered eligible securities if they are not exercisable for at least three years and if the exercise premium is at least 10%.

Rule 144a could allow growth companies to enjoy higher valuations.

What's a QIB?

The rule defines a *qualified institutional buyer* as an institution that owns and invests, on a discretionary basis, $100 million or more in securities of *unaffiliated issuers*.

The SEC estimates that approximately 4,000 institutions meet the requirements necessary to become a QIB. Institutions most likely to qualify will be insurance companies, banks, savings & loan institutions, broker/dealers, investment companies and investment advisers. But it is also possible that a venture capital firm might meet the definition of a QIB.

Banks and savings & loan institutions, in addition to owning $100 million or more in securities, must have an audited net worth of at least $25 million.

Registered broker/dealers qualify if they own and invest, on a discretionary basis, at least $10 million in securities of unaffiliated issuers. (A registered broker/dealer may also act as a "riskless principal" for qualified institutional buyers. A riskless-principal transaction is defined as the purchase of Rule 144a securities and their simultaneous sale to a QIB.

Mutual funds haven't been significant purchasers of private placements because they are barred from investing more than 10% of their assets in illiquid securities. A mutual fund can invest in Rule 144a securities if the fund's board determines that the securities aren't illiquid.

While a determination of an investment's liquidity may be very important, the board must be equally concerned with being able to observe a reasonable measurement of daily market value. Clearly, therefore, an efficient market will be essential to attract large-scale participation by open-end mutual funds in Rule 144a securities.

There are three possible ways in which a venture capital fund can qualify as a QIB. A venture capital fund can qualify if it is established as a limited partnership and has capital under management of $100 million or more. Venture Economics, Inc. estimates that 54 venture capital funds meet that size requirement. It is highly unlikely that these funds are registered under the Investment Company Act of 1940.

In fact, venture firms generally have sought to avoid registration under the '40's Act by keeping the number of limited partners in a fund to under 100 and by timing offerings of subsequent funds far enough apart to avoid "integration of the funds." If an investor cannot distinguish between the offering of one fund versus another fund managed by the same venture

firm, the funds would be considered integrated, or of the same offering. If integration occurs, the investors in the integrated funds are added together for purposes of determining the 100-investor limit.

A Family Affair

A venture capital investment company also can qualify if it is registered under the Investment Company Act of 1940 and owns or invests at least $100 million in securities of unaffiliated issuers.

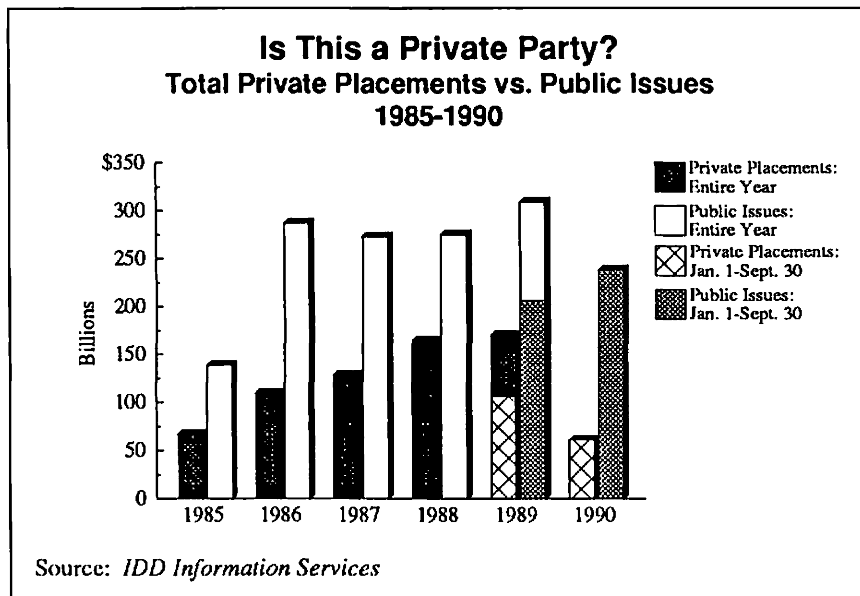
In computing the $100 million target, a registered investment company can aggregate funds in a "family of investment companies." However, each investment company within the "family" must have the same adviser.

For example, if a venture firm manages five $20 million funds, each of which is registered as an investment company, then the five funds can be aggregated to reach the $100 million minimum required of a QIB. However, if four of the funds are registered investment companies and the fifth is not, then only the four could be aggregated. The resulting $80 million total wouldn't be sufficient for the firm to qualify.

Venture Economics estimates that 95 independent venture capital firms have at least $100 million under management in multiple funds, though how many of the funds are registered investment companies isn't known. (The 95 firms have combined assets of $19.7 billion.)

Back to the Future

In addition, business development companies (BDCs) and publicly traded small business investment companies (SBICs) would be considered registered investment companies. A BDC is a closed-end fund that invests in and provides significant managerial assistance to



Source: *IDD Information Services*

emerging growth companies. BDCs, which were popular in the 1970s, have largely faded from the investment scene, though the enabling legislation remains in force.

The third way venture firms could qualify is through SBICs. Licensed by the U.S. Small Business Administration, SBICs would qualify as QIBs if they own or invest at least $100 million in securities of unaffiliated issuers. According to the National Association of Small Business Investment Companies, several bank-related SBICs meet this criterion.

A venture fund that meets the requirements of one of the above categories, however, might still be excluded if it is "affiliated" with its investments. At this early stage in the development of Rule 144a, it's unclear how the SEC will apply the unaffiliated-issuers requirement to venture funds.

The SEC could, for example, view investments as affiliated with a venture fund if a general partner is a board member of the venture-backed company, if the fund is a significant investor in the company, or if the fund holds contractual rights that are superior to those of other investors or the company founders. As a result, many of a venture capital firm's investments could be excluded in calculating the $100 million asset requirement.

Some Good News

There is another risk as well. It comes into play if a venture fund has been exempted from registering under federal securities law and meets the general guidelines of a QIB. In that case, the fund's affiliations with its investments could open the way for the SEC to claim jurisdiction if the fund decided to become a PORTAL subscriber or trade in Rule 144a securities as a QIB.

The good news, however, is that the SEC hasn't yet taken a position on these affiliation issues. It may be necessary for a venture firm's legal counsel to submit questions to the SEC requesting clarification of these issues.

Information, Please

Rule 144a also requires a seller to provide a prospective buyer, upon request, with *certain issuer information* if the securities-issuing company doesn't already file with the SEC. The resale transaction won't be con-

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sidered crossed, or completed for PORTAL purposes, until the prospective buyer receives the information.

While not as extensive as a public offering, the information must summarize the issuer's business, products and services. It must also include financial statements (balance sheet, income statement and retained earnings statements) for the company's most recent reporting period and its two preceding fiscal years.

Excluded from this requirement are issuers that file periodic reports with the SEC under the Exchange Act and foreign firms that apply the Rule 12g3-2(b) exemption.

Foreign issuers whose securities trade abroad need to provide only the public information required by their home country or the exchange where their securities trade. (Importantly, the foreign issuer isn't required to present its financial statements in accordance with U.S. accounting principles, or reconcile the differences between U.S. accounting principles and those of the home country.)

Tacking and Tolling

In adopting Rule 144a, the SEC also amended Rules 144 and 145. Under Rule 144, restricted securities must be held for at least two years before they are eligible for limited public resale to institutions, or for three years without any limitations, assuming the holder isn't affiliated with the issuer.

Prior to the amendment, a resale or short sale within a given holding period would trigger a new minimum two-year holding period for the purchaser. The amendment to Rule 144, however, allows the buyer to combine, or "tack," the time the seller has held the restricted security, in calculating the minimum two-year holding period before limited public resale. Purchasers cannot be affiliated with the issuer, or else a new minimum holding period begins.

This amendment applies to *all* restricted securities issued through private placements or resold under Rule 144a. Also, short sales, or "put" options, on the restricted securities will not start a new minimum holding period (or "toll" the existing holding period). Because the holding period requirements of Rule 145 are derived through Rule 144, changes to Rule 144 modify Rule 145.

The Point of PORTAL

The SEC also approved PORTAL, a screen-based computer and communications system proposed by the National Association of Securities Dealers (NASD). PORTAL, an acronym for Private Offerings, Resales and Trading through Automated Linkages, is designed to provide a centralized market for Rule 144a securities and support the negotiation, clearance and settlement of private placements.

The objective of PORTAL is twofold:

- Restrict the Rule 144a securities market to QIBs. All PORTAL subscribers and securities listed must satisfy SEC qualification standards. All PORTAL transactions are monitored for compliance with the rule.

A venture capital fund can qualify as a QIB in three ways.

- Automate the Rule 144a securities market. The private placement market currently is fragmented and utilizes paper and the telephone to execute trades or list offerings. A screen-based system is expected to enhance market efficiency in obtaining quotes, identifying interest in pending placements, and in confirming trades.

So far, PORTAL has attracted 56 subscribers, of which 41 are broker/dealers and 15 are QIBs. In the meantime, not to be left out of a potentially lucrative Rule 144a market, both the American Stock Exchange (Amex) and the New York Stock Exchange (NYSE) have announced the development of rival screen-based systems.

As the chart on page 14 shows, private placements have been a growing source of corporate finance, totaling $170 billion, or 35% of all corporate financings, in 1989. This year, however, there has been a significant drop in private placements. The falloff reflects the slowdown in mergers and acquisitions, and the related decline in privately placed junk bonds, as well as growing economic uncertainty. Consequently, private placements in the first nine months of 1990 fell nearly 47% from the year-earlier period, to $61.1 billion.

High-Tech Finance

Recently, emerging growth companies have been using private placements as a financing vehicle, given the slow initial public offering (IPO) market. The table on page 16 compares high-technology private placement activity with venture-backed IPOs.

Many industry participants expected Rule 144a to open a floodgate of private placement offerings. But the anticipated rush has not yet occurred. There have been only 19 Rule 144a equity issuers so far, and all but one — Browning Ferris Industries Inc. — has been foreign. Of the estimated market of 4,000 QIBs, only about 10% have bothered to qualify as QIBs under the NASD's

PORTAL system, and of those only 56 have become PORTAL subscribers.

What is impeding the growth of the Rule 144a securities market? The financial markets overall, of course, have been weakened by the domestic and global economic slowdown, the recent U.S. budget impasse and the prospect of war in the Middle East. The plunge in junk-bond financings is an added factor. However, external market conditions cannot completely explain the disappointing performance to date. Much is the result of the following:

Getting Liquid

• *An assumption that private-placement issuers and investors want liquidity.* Issuers would prefer a more liquid market, because it would reduce financing costs. However, traditional purchasers of private placements, such as the large insurance companies, are buy-and-hold investors. Typically, these investors sacrifice investment liquidity for higher returns (i.e., charge an illiquidity premium) and for the ability to negotiate special covenants, conditions and registration rights in the private placement agreement.

When the SEC was considering Rule 144a proposals, it received comments suggesting that only large institutions be qualified as QIBs initially, with smaller institutions phased in over time. If the SEC eventually lowers the $100 million threshold, liquidity is likely to be an important factor to smaller institutional investors, which can't extract the same terms and conditions from issuers as the large institutions. Open-end mutual funds, a potentially large participant in the Rule 144a market, require liquidity because their investors can demand redemption of funds at any time. As the 144a securities market evolves — and, presumably, as trading volume develops — liquidity could become a more important consideration, even for investors that currently approach the market with a buy-and-hold orientation.

Low-Tech Trading

• *Lack of a practical mechanism for trading Rule 144a securities.* There is a need for an electronic clearing system that will allow market makers and institutional investors to see quotes and watch trends. PORTAL has met its first objective of ensuring the eligibility of participants, but so far has fallen short of the second goal, which is to automate the markets.

Today, the PORTAL system only lists the available Rule 144a securities. Trading occurs via telephone from institutional investors to broker/dealers that make markets in 144a securities. The PC-based system is cumbersome and unsophisticated compared with the trading terminals used in other securities markets. Future releases of PORTAL, or of the NYSE or Amex electronic systems, could correct these deficiencies.

No 'Two-Tier' Markets

• *Restrictions on eligible securities.* Currently, Rule 144a securities cannot be of the same class as securities listed on a U.S. exchange or quoted on NASDAQ. This fungibility restriction was meant to address the NYSE's concerns about a "two-tier" market developing that would attract securities from the public into the private market.

The fungibility restriction poses problems for domestic equity issuers that rely on common equity as a primary financing vehicle and that depend on an IPO or a public offering as the key way for investors to obtain liquidity. It is highly unlikely that all Rule 144a holders will or can be "selling shareholders" in the public offering. Thus, securities of the same class would be trading simultaneously at the registration's effective date, violating the same-class prohibition.

Avoiding the issue of same class is easier for debt securities, where terms relating to interest rate, maturity, subordination, security, convertibility, call and redemption can be altered in a myriad of ways. Convertible securities (whether debt or preferred equity) could be a problem, as they normally convert to common equity at, or prior to, a public offering.

'Haircut's' Too Short

• *Broker/dealers unwilling to underwrite "illiquid" issues.* The Uniform Net Capital Act of 1975 requires broker/dealers to maintain

Staying in the Chips

High-Tech Private Placements vs. IPOs

	Private Placements			Venture-Backed IPOs		
Year	Dollar Amount	Number of Issues	Average Issue Size	Dollar Amount	Number of Issues	Average Issue Size
1985	$2,019.60	88	$22.95	$ 843.30	47	$17.94
1986	1,327.10	45	29.49	2,128.20	98	21.72
1987	999.00	51	19.59	1,839.50	81	22.71
1988	3,029.90	62	48.87	788.50	36	21.90
1989	2,956.00	43	68.74	996.00	39	25.54
5-yr. Average	$2,066.32	58	$37.93	$1,319.1	60	$21.96

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net capital equal to 100% of the offering amount of an illiquid equity issue. Investment bankers, who refer to this requirement as a 100% "haircut," are unwilling to underwrite Rule 144a equity issues in private companies whose securities have had no previous market.

Investment bankers have more incentive to use IPOs and debt offerings, which have lower net capital requirements.

That's Private!

• *Information requirements of private companies for resale of Rule 144a securities.* Although the information disclosure rules are much less demanding than for public companies, they nonetheless impede the efficiency of the market, which is moving toward a fully computerized trading mechanism.

Under Rule 144a as adopted, a trade won't be completed at the posted bid or offer price unless the buyer has received the required information. Although the seller of the securities is liable for providing that information to the prospective buyer, the burden ultimately resides with the issuer. Consequently, the issuer is involved in the resale transaction to a far greater extent than in a public securities transaction.

In many cases, information provided to a prospective purchaser will be dated. While it isn't required, an issuer might find that a purchaser expects updated information prior to purchase.

This information requirement initially could be a burden for private, emerging growth companies that are considering the use of the Rule 144a securities market. The information requirement might make a Rule 144a private placement less attractive than a public offering to an emerging growth company, despite the lower cost of capital.

Weighing the Trade-Off

Will the benefits of a lower capital cost and limited disclosure requirements attract emerging growth companies to issue Rule 144a securities, or will they opt for some other financing alternative, such as a public offering or corporate partnering?

As the securities market evolves, some or all of the above concerns are likely to be addressed. As originally proposed, Rule 144a would have permitted a much broader group of institutional investors to trade private placements. The original proposal didn't contain the restriction against same-class securities, or the information disclosure requirement.

Institutions could begin to dominate later-stage financing.

In issuing Rule 144a, the SEC stated that "it intends to monitor the evolution of this market and to revisit the Rule with a view to making any appropriate changes."

Opportunity Ahead

Initially, only large domestic and foreign companies will benefit from Rule 144a, given the gradual phase-in and the impediments described above. However, the one immediate opportunity for both venture capital investors and emerging growth companies is not Rule 144a, but the related amendment to Rule 144 dealing with "tacking" and "tolling."

The tacking/tolling provision of Rule 144 will favorably affect the financing of emerging growth companies in the following ways:

• *Returns to early-stage venture investors could rise.* Returns to early-stage venture investors typically diminish when later-round financings by larger venture firms dilute the ownership positions of the early investors. Most early-round investors are small seed funds and cannot continue to make the same proportionate investment in later rounds.

Prior to the Rule 144 amendment, early-stage investors had little incentive to sell a position to a later-round investor. The illiquidity discount due to the reinitiation of the minimum holding period, among other things, has limited resales of private placements. It might now be possible for early-round investors that can't participate in later rounds to sell their positions at, or near, the later-round price. As a result, small, early-stage investment funds could become more attractive vehicles than in the past.

• *Returns to later-stage investors could potentially decline.* The increase in liquidity could significantly reduce, or even eliminate, the illiquidity discount implicitly assessed on venture investments. As a result, later-stage venture investors will likely pay more for their investments.

Greater liquidity also will attract new types of investors, further pressuring returns in an already-crowded later-stage investment market. On the positive side, liquidity gives venture investors more options for increasing or decreasing their holdings in a given investment (or tolling) after a public offering.

• *Emerging growth companies could see higher valuations.* Greater liquidity as a result of tacking will allow venture firms to pay more for a financing round and still enjoy the same return. Emerging growth companies will get more investment dollars and higher valuations.

The tacking provision, however, could adversely affect an emerging

growth company if early-round investors try to sell their holdings when the company is raising later-round funds. In cashing out, the early-round investors would divert funds that would have gone to the growth company if the tacking provision wasn't in effect.

Corporations could use Rule 144a securities to spin off technology subsidiaries.

In the future, Rule 144a could have even more sweeping effects on venture capital firms and emerging growth companies, if the SEC revisits the measure with the intent of broadening and deepening the market.

The SEC could, for example, increase the number of institutions involved in Rule 144a investing by reducing the $100 million threshold for QIBs, or by removing the same-class securities ban. The following are changes that could occur as Rule 144a evolves:

• *IPOs could occur later in a venture-backed company's development, when it is larger and more mature.* One of an IPO's primary objectives is to provide liquidity for early-stage investors. A Rule 144a offering could be an alternative to a mezzanine round or an IPO. Selling investors could receive pricing at or near the traditional IPO price.

Once the company is larger and more established, Rule 144a institutional investors could take the company public, selling their shares to individuals and mutual funds.

A Rule 144a financing might be less expensive than a traditional private placement or a mezzanine venture round, though it won't be as attractively priced as a typical IPO. Nevertheless, an emerging growth company might favor a 144a offering because the limited disclosure requirements would allow it to manage for the long-term and not for quarterly earnings. Furthermore, an IPO at a later stage of a company's growth is likely to result in a less-volatile market for the company's shares.

• *Later-stage venture investors could see lower returns.* The added liquidity in later-stage and mezzanine financing rounds would depress the returns on these investments.

Institutional investors might begin to compete with venture firms for later-stage financings. Institutions that previously invested in venture funds might instead choose to invest side-by-side with them in later-stage financings. In the search for higher returns, venture firms might show renewed interest in early-stage investments.

• *Corporate spin-offs could utilize Rule 144a securities.* To finance technology development without adversely affecting the balance sheet or income statement, a large corporation might form a subsidiary that would sell Rule 144a securities, with the parent company retaining a majority. A corporation could also spin off a non-core division at a near-public offering valuation, while avoiding significant disclosures about the spin-off's business operations or finances.

• *A Rule 144a venture fund could emerge.* Such a fund would invest in various stages, ranging from early-stage investments all the way through a later-stage alternative to the mezzanine round. In addition, a Rule 144a fund could purchase positions in profitable private companies when the founders want liquidity.

One possible vehicle for a Rule 144a fund is the business development company, which could attract renewed interest. As Glass-Steagall barriers fall, Rule 144a funds also could be formed by banks that invest in private placements and are QIBs. The result is likely to be the financing of emerging growth companies through investment vehicles that combine aspects of investment banking and venture capital, akin to merchant banking.

Summary

As originally proposed, Rule 144a would have applied to a much broader number of institutions and issuers. As adopted, Rule 144a is encumbered by procedural and structural impediments that make it difficult for emerging growth companies to take full advantage of the opportunity. The initial reluctance of institutions to purchase Rule 144a offerings hasn't helped. In its current form, Rule 144a favors foreign issuers but does little to reduce capital costs for domestic companies. As the market develops, this inequality should diminish.

A Rule 144a fund could invest in and trade private securities.

In the future, Rule 144a could have a major impact on later-stage venture investments. IPOs will likely occur later in a company's life-cycle, and the market for those IPOs will be individual investors and mutual funds.

Increased liquidity will result first from the amendment to Rule 144, and later from the expanded applica-

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tion of Rule 144a offerings. That will reduce or eliminate the illiquidity discount that venture investors apply to their investments. As a result, later-stage venture funds will likely experience intensified pressure on returns.

Emerging growth companies will benefit by obtaining funds at lower cost. Companies utilizing Rule 144a placements will also benefit from the limited disclosure requirements, which reduce information costs and maintain the privacy of sensitive data.

Venture funds and investment banks should consider developing funds that qualify as institutional investors under Rule 144a as a means to invest in emerging growth and profitable private company opportunities. □