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Evasion and Flowback in the Regulation S Era: Strengthening U.S. Investor Protection While Promoting U.S. Corporate Offshore Offerings

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Abstract

This Note examines whether the structure of Regulation S has caused increased flowback of unregistered securities into the United States. Part I discusses the development of the offshore capital markets and the registration requirements of the Securities Act. Part I also details the evolution of the SEC's application of the Securities Act registration requirements to international securities sales, and summarizes Regulation S. Part II discusses the benefits to issuers of using Regulation S, and the effect that Regulation S has had on U.S. corporate participation in the offshore markets. Part II also analyzes the threat that flowback poses to the Securities Act disclosure requirements, and examines the mechanisms through which unregistered securities flow back into the United States. Part III argues that neither SEC enforcement efforts, nor the currently extant private remedy, can effectively curtail the flowback problem caused by Regulation S. In addition, Part III provides recommendations for amending Regulation S to ensure greater protection for U.S. investors and greater certainty for U.S. issuers in offshore transactions. This Note concludes that the SEC should revisit Regulation S in order to achieve a workable balance between access for issuers and protection for investors.

NOTES

EVASION AND FLOWBACK IN THE REGULATION S ERA: STRENGTHENING U.S. INVESTOR PROTECTION WHILE PROMOTING U.S. CORPORATE OFFSHORE OFFERINGS

*Josh Futterman**

INTRODUCTION

The 1980's was a period of explosive growth in the internationalization of the securities markets.¹ The value of all securities issued outside of issuers' home markets in 1989 was six times that of 1980.² Despite this growth, the Securities and Exchange Commission's ("SEC" or "Commission") aggressive position regarding the extraterritorial application of the Securities Act of 1933³ ("Securities Act") continued to limit U.S. corporations' ability to compete with non-U.S. corporations⁴ for investment

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1. See CHARLES J. JOHNSON, JR., *CORPORATE FINANCE AND THE SECURITIES LAWS* 457-61 (1990). Securities markets are exchanges through which debt and equity securities are traded by investors. See RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 1-27 (7th ed. 1992) (discussing overview of securities markets). The internationalization of the securities markets consists of the issuance and trading of securities between issuers and investors in different countries. See D.E. AYLING, *THE INTERNATIONALISATION OF STOCKMARKETS* 3-5 (1986) (discussing internationalization of the capital markets).

2. See HAZEL J. JOHNSON, *THE NEW GLOBAL BANKER* 91-104 (1994) [hereinafter *GLOBAL BANKER*]. International bond issues grew from US\$40 billion in 1980 to over US\$250 billion in 1989. *Id.* at 94 (Exhibit 3-4). International equity issuance grew from practically nothing in 1984 to over US\$18 billion in 1987. *Id.* at 103 (Exhibit 3-8).

3. Securities Act of 1933, 15 U.S.C. §§ 77a-77z (1988 & Supp. V 1993). The Securities Act of 1933 was passed during President Franklin Delano Roosevelt's first 100 days in office. See EDWARD T. McCORMICK, *UNDERSTANDING THE SECURITIES ACT AND THE SEC* 20-24 (1948) (discussing history of Securities Act). The purpose of the Securities Act is to ensure full disclosure in the registration statement and prospectus for new securities. SARKIS J. KHOURY, *THE DEREGULATION OF THE WORLD FINANCIAL MARKETS* 70 (1990).

4. See Samuel Wolff, *Offshore Distributions Under the Securities Act of 1933: An Analysis of Regulation S*, 23 *LAW & POL'Y INT'L BUS.* 101, 112-16 (1991/92) (discussing dissatisfaction of U.S. market participants with SEC regulation of offshore capital markets prior to 1990). Preparation of a registration statement that complies with the Securities Act requirements costs hundreds of thousands of dollars. Don Berger, *Offshore Distributions of Securities: The Impact of Regulation S*, 3 *TRANSNAT'L L.* 575, 578 (1990).

from the offshore markets.⁵ To remedy this problem, on April 30, 1990, as part of a relaxation of the Securities Act registration requirements,⁶ the SEC adopted Regulation S.⁷

Regulation S provides a standard set of rules that may be followed by offshore issuers⁸ and purchasers of unregistered corporate securities⁹ to ensure that their offshore transactions need not be registered under the Securities Act.¹⁰ As a result, Regulation S has made offshore issuance of unregistered securities by U.S. corporations less expensive and easier than it was prior to 1990.¹¹ Although Regulation S was designed to allow greater access to offshore funding for U.S. issuers,¹² in promulgating the

5. See JOHN F. MARSHALL & M.E. ELLIS, *INVESTMENT BANKING & BROKERAGE* 78-79 (1994) (discussing offshore markets). The offshore markets are a set of virtually unregulated extraterritorial securities markets that facilitate issuance and trading of securities across national borders. *Id.* at 79. The offshore capital markets originally developed in Europe and are often called the Euromarkets. See JOHNSON, *supra* note 1, at 461. Offshore equity securities are often called Euroequities. *Id.* at 457. Offshore debt securities are either called Eurobonds or foreign bonds. See AYLING, *supra* note 1, at 97-98.

6. See Fred A. Little, *Regulation S And Rule 144A*, C895 ALI-ABA 445, 447-49 (1994) (discussing two regulations adopted in Spring of 1990 to improve U.S. corporate access to offshore markets). Along with Regulation S, the SEC also promulgated Rule 144A, which provides an exemption from registration for private placements of new securities made to sophisticated institutional investors. Rule 144A — Private Resales to Institutions, 17 C.F.R. § 230.144A (1994).

7. Regulation S—Rules Governing Offers and Sales Made Outside of the United States Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.901-230.904 (1994).

8. Securities Act of 1933 § 2(4). The Securities Act defines issuer in part as “every person who issues or proposes to issue any security.” *Id.*

9. *Id.* § 5. Section 5 of the Securities Act requires all issuers to file registration statements with the SEC prior to the offer or sale of any security. *Id.* Various provisions of the Securities Act grant authority to the SEC to exempt certain types of securities and interpret existing statutory exemptions. See, e.g., Securities Act of 1933 § 3(b)-(c).

10. See John R. Coogan & Thomas C. Kimbrough, *Regulation S Safe Harbors For Offshore Offers, Sales And Resales*, *INSIGHTS*, Aug. 1990, at 3. The primary benefit for issuers will be greater certainty in planning offshore transactions. *Id.* at 3. Prior to the adoption of Regulation S, issuers were forced to rely on a complex amalgam of SEC releases, no-action letters and private conversations with SEC officials to plan offshore transactions. John M. Allen, Jr. & Lee M. Weinberg, *When A Regulation S Offering Makes Sense*, *INT'L FIN. L. REV.*, Aug. 1993, at 39.

11. See Kevin Kelley & Alan Bannister, *US Investors and Offshore Offerings*, *EUROMONEY*, April 1993, at 166 (discussing benefits to issuer of Regulation S).

12. See *Offshore Offers and Sales*, Securities Act Release No. 6863, 55 Fed. Reg. 18,306, 18,321 (May 2, 1990) (discussing cost-benefit analysis of Regulation S) [hereinafter *Adopting Release*]. In the Regulation S Adopting Release, the SEC stated as follows:

It appears to the Commission that, while it is possible that some additional costs to issuers, distributors or other sellers may result from structuring a trans-

rules, the SEC had to comply with its mandate to protect U.S. investors from public offers and sales of unregistered securities.¹³ The SEC, therefore, imposed a variety of restrictions on offshore issuers and their distributors in order to prevent the resale into the United States of unregistered corporate securities initially sold to offshore investors pursuant to Regulation S.¹⁴ This return of unregistered offshore securities has been termed flowback.¹⁵

In the four years since Regulation S took effect, it has helped to open up the offshore markets for U.S. issuers.¹⁶ Counter to the SEC's expectations,¹⁷ however, during the same period, flowback has increased significantly.¹⁸ Some of this flowback has occurred because issuers and offshore investors have intentionally used Regulation S to avoid the Securities Act registration requirements, an act that the SEC considers illegal.¹⁹

action in accordance with the requirements of [Regulation S], such costs will be outweighed by the savings of the costs of registration and the benefit derived from assurance that registration need not be undertaken. In addition, the Commission believes that the streamlined method to assure that securities come to rest outside the United States will also reduce costs.

Id.

13. See S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933) (discussing philosophy of Securities Act). The SEC explicitly recognizes its duty to protect investors purchasing on the U.S. securities markets in the Adopting Release. Adopting Release, 55 Fed. Reg. 18,306, 18,308.

14. Adopting Release, 55 Fed. Reg. 18,306, 18,313. The SEC has stated that "the criteria used to divide securities into three groups . . . were chosen because they reflect the likelihood of flowback into the United States and the degree of information available to U.S. investors regarding such securities." See *id.* (detailing three basic propositions underlying Regulation S).

15. Proposed Rules: Offshore Offers and Sales, 53 Fed. Reg. 22,661, 22,665 (June 17, 1988) [hereinafter Proposed Rules]. The SEC defines flowback as an indirect distribution in the U.S. markets of unregistered securities initially sold offshore. *Id.*

16. See Kelley, *supra* note 11, at 166. Regulation S has reduced the uncertainty and procedural requirements that existed prior to the adoption of the regulation by the SEC. *Id.* In addition, Regulation S has increased the ability of offshore offerings to reach certain U.S. investors without registration. *Id.*

17. See Proposed Rules, 53 Fed. Reg. 22,661, 22,665 (discussing SEC position that rules of Regulation S must ensure against indirect distribution in U.S. markets).

18. See Laurie P. Cohen, *Rule Permitting Offshore Stock Sales Yields Deals That Spark SEC Concerns*, WALL ST. J., Apr. 26, 1994, at C1 (discussing flowback after adoption of Regulation S). SEC officials believe that the rule has resulted in many illegal transactions. *Id.* It has also opened the door for con artists to swindle small U.S. issuers. John R. Emshwiller, *Need For Money Pulls Young Firms Into Risky Deals*, WALL ST. J., Mar. 31, 1992, at B2.

19. See 17 C.F.R. §§ 230.901-230.904, prelim. n.2 (1994) (prohibiting use of Regulation S as part of a scheme to avoid Securities Act registration requirements).

The rest of the transactions that have led to flowback have comported with the terms of Regulation S, but not with the SEC's goal to encourage long-term investment in U.S. corporations by offshore purchasers.²⁰ Regardless of whether the flowback is valid or invalid, any flowback threatens the disclosure scheme created by the Securities Act and, consequently, the ability of the SEC to protect U.S. investors.²¹

This Note examines whether the structure of Regulation S has caused increased flowback of unregistered securities into the United States. Part I discusses the development of the offshore capital markets and the registration requirements of the Securities Act. Part I also details the evolution of the SEC's application of the Securities Act registration requirements to international securities sales, and summarizes Regulation S. Part II discusses the benefits to issuers of using Regulation S, and the effect that Regulation S has had on U.S. corporate participation in the offshore markets. Part II also analyzes the threat that flowback poses to the Securities Act disclosure requirements, and examines the mechanisms through which unregistered securities flow back into the United States. Part III argues that neither SEC enforcement efforts, nor the currently extant private remedy, can effectively curtail the flowback problem caused by Regulation S. In addition, Part III provides recommendations for amending Regulation S to ensure greater protection for U.S. investors and greater certainty for U.S. issuers in offshore transactions. This Note concludes that the SEC should revisit Regulation S in order to achieve a workable balance between access for issuers and protection for investors.

I. THE OFFSHORE APPLICATION OF THE SECURITIES ACT REGISTRATION REQUIREMENTS

In response to increased U.S. corporate activity in the international securities markets over the last several decades,²² the SEC has, on several occasions, reexamined its position regarding

20. See Cohen, *supra* note 18, at C1 (discussing flowback since adoption of Regulation S).

21. See H.R. Doc. No. 12, 73d Cong., 1st Sess. 1-2 (1933) (discussing underlying purposes of Securities Act).

22. Proposed Rules, 53 Fed. Reg. 22,661, 22,665. The SEC stated that a new approach to the offshore application of the Securities Act registration requirements was necessary because of the development of active international trading markets, a large

the extent to which the registration requirements of the Securities Act apply to offshore securities transactions involving U.S. corporations and investors.²³ Since 1933, the SEC has consistently held that offshore offers and sales of securities that have no domestic impact²⁴ need not be registered under the Securities Act.²⁵ The SEC has derived this view from its determination that the Securities Act registration requirements are not meant to protect overseas investors.²⁶ The Commission, however, did not adopt a standard set of guidelines that U.S. corporations could follow to ensure that their offshore offerings remained outside of the reach of the Securities Act registration requirements until 1990, when it adopted Regulation S.²⁷

A. *The Offshore Securities Markets*

Over the last two decades securities markets throughout the world have become increasingly interconnected.²⁸ This globalization has been due to a combination of rapid growth in the world economy and substantial improvements in computer and financial technology.²⁹ Investment banks³⁰ that participate in

increase in offshore offerings, and significant involvement by U.S. investors in the international markets. *Id.*

23. *Id.* For corporations that seek to raise capital in the offshore markets, the most important question is the scope of the extraterritorial reach of the Securities Act registration requirements. *Id.*

24. See Wolff, *supra* note 4, at 108-09. The SEC interpreted "no domestic impact" to mean that securities sold by U.S. corporations through an offshore primary offering must be distributed abroad solely to non-U.S. persons in such a way as to ensure that they would not be redistributed into the United States by offshore purchasers without a valid exemption from registration. *Id.*

25. See Berger, *supra* note 4, at 577-81 (discussing SEC's historical approach to offshore application of Securities Act registration requirements).

26. See Registration of Foreign Offerings by Domestic Issuers; Registration of Underwriters of Foreign Offerings as Broker-Dealers, Securities Act Release No. 4708, 1964 WL 3661, *1 (SEC) (July 9, 1964) (discussing SEC position that offshore securities sales that have no domestic impact are exempt from registration).

27. See Allen & Weinberg, *supra* note 10, at 39 (discussing how Regulation S clarifies extraterritorial application of Securities Act registration requirements).

28. See AYLING, *supra* note 1, at 1-22 (discussing internationalization of securities markets).

29. See JOHNSON, *supra* note 1, at 458-59 (discussing factors underlying internationalization of securities markets); see also AYLING, *supra* note 1, at 43-57 (discussing historical overview of internationalization of securities markets).

30. See MARSHALL & ELLIS, *supra* note 5, at 4-6 (discussing definition of investment banking). The Glass-Steagall Act, enacted by the U.S. Congress in 1933, split the U.S. banking industry into two parts: commercial and investment banking. Banking (Glass-Steagall) Act of 1933, ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered

various facets of offshore distribution have adapted the techniques of domestic securities issuance to the international markets.³¹

1. The Rise and Growth of the International Capital Markets

During the years surrounding World War II,³² U.S. industry supported its growth almost exclusively through the domestic securities markets.³³ Beginning in the late 1950's, however, U.S. corporations began a period of rapid expansion into overseas markets.³⁴ In the 1960's, the U.S. government passed a series of laws that placed significant limitations on the ability of multinational corporations to use investment capital raised in the United States for offshore projects.³⁵ These restrictions forced U.S. corporations to begin to use the offshore securities markets to satisfy their demand for capital.³⁶ The demise of the Bretton Woods regime³⁷ in March 1973,³⁸ which resulted in the adoption

sections of 12 U.S.C.). Glass-Steagall states that only commercial banks can take deposits and directly lend money to corporations. MARSHALL & ELLIS, *supra* note 5, at 4. Glass-Steagall declares that only investment banks can underwrite securities, take positions for their own accounts in certain types of securities, or act as agents for others in securities transactions. *Id.*

31. See AYLING, *supra* note 1, at 102 (discussing offshore issuance procedures).

32. See CONCISE COLUMBIA ENCYCLOPEDIA 930 (Judith S. Levey & Agnes Greenhall eds., 1983) [hereinafter COLUMBIA ENCYCLOPEDIA] (discussing World War II). World War II commenced in 1935 and ended in 1945. *Id.*

33. Wolff, *supra* note 4, at 108-09. Few international offerings were made during the first few decades after the Securities Act was enacted. *Id.*

34. See JOHNSON, *supra* note 1, at 461. During the 1950's, the strength of the dollar forced U.S. companies to invest heavily in overseas manufacturing plants in order to remain competitive. *Id.*

35. GLOBAL BANKER, *supra* note 2, at 87.

36. See JOHNSON, *supra* note 1, at 462 (discussing increase in U.S. corporate use of offshore funding). Between 1971 and 1978 U.S. corporations led all countries, except Canada, in international bond ("Eurobond") issuance. See DAVID F. LOMAX & P.T.G. GUTMANN, THE EUROMARKETS AND INTERNATIONAL FINANCIAL POLICIES 9 (Table 1.9) (1981) (discussing new international bond issues by country from 1971 to 1978).

37. See BARRY EICHENGREEN & PETER B. KENEN, *Managing the World Economy under the Bretton Woods System: An Overview*, in MANAGING THE WORLD ECONOMY: FIFTY YEARS AFTER BRETTON WOODS 3, 11-15 (1994). The Bretton Woods Conference of 1944, held in Bretton Woods, New Hampshire, led to the introduction of a fixed exchange rate system pegged to the U.S. dollar. *Id.* at 13. At the meeting, the allied industrialized nations agreed to create the International Monetary Fund to deal with future balance of payments problems, as well as currency stabilization. *Id.* The conferees also agreed to develop the World Bank, also called the International Bank for Reconstruction and Development, to provide international financial assistance to the developing countries of the world. *Id.* at 14; see ARMAND VAN DORMAEL, BRETTON WOODS: BIRTH OF A MONETARY SYSTEM (1978) (discussing history of Bretton Woods Accords).

of a floating exchange-rate system,³⁹ and the accumulation of petrodollars⁴⁰ by the member states of the Organization of Petroleum Exporting Countries ("OPEC"),⁴¹ provided the sparks for the explosion of the international securities markets.⁴² By the end of the 1980's, the offshore capital markets had become an important source of both domestic and global project financing for public companies worldwide.⁴³

Although the tremendous growth of the world economy since World War II⁴⁴ has been the primary impetus for the globalization of the securities markets, significant advances in

38. See AYLING, *supra* note 1, at 50-51 (discussing demise of Bretton Woods accord).

39. See AYLING, *supra* note 1, at 19 (discussing relationship between international currency markets and international securities markets). A floating exchange rate system is one in which currencies are not pegged to the price of gold or some other commodity, but rather float against one another based on the international currency market's beliefs about the relative strengths of the economies of each participating nation. See RICHARD S. THORN, *INTRODUCTION TO MONEY AND BANKING* 510-22 (1976) (discussing various types of currency exchange systems). The system that replaced the Bretton Woods regime is, in reality, a number of multi-lateral arrangements that allow countries to have either floating, fixed or managed exchange rates. AYLING, *supra* note 1, at 51-52. The increased control over monetary policy won by the governments of the industrialized world after the collapse of the Bretton Woods system came at the expense of certainty for business. *Id.* at 52. Once the industrialized countries switched to floating rates, however, the financial markets quickly developed a variety of new services to assist international market participants. *Id.*

40. AYLING, *supra* note 1, at 52-53. The oil shocks of 1973 and 1979 led to a drastic increase in the price of oil, and a commensurate rise in the amount of capital in the hands of the OPEC countries. *Id.* This newfound capital flowed into the United States where it was invested and came to be known as Petrodollars. *Id.*

41. See COLUMBIA ENCYCLOPEDIA, *supra* note 32, at 628. In 1973, OPEC consisted of the following member states: Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, United Arab Emirates, and Venezuela. *Id.*

42. See AYLING, *supra* note 1, at 19-21 (discussing importance of foreign exchange markets in scheme of international finance). The floating exchange rate regime provided the liquidity necessary for large-scale international investment. *Id.* at 21. Petrodollars provided the necessary investment capital. See JOHNSON, *supra* note 1, at 462 (discussing how petrodollars led to growth of Euromarkets). The explosion of the international securities markets is demonstrated by the fact that although new international bond offerings totaled only US\$24.9 billion in 1978, of which US\$3 billion had been issued by U.S. public and private institutions, LOMAX & GUTMANN, *supra* note 36, at 9 (Table 1.9), by 1986 new international bond issues had reached US\$227.1 billion worldwide, and by 1991 they totaled almost US\$300 billion. MORRIS GOLDSTEIN ET AL., *INTERNATIONAL CAPITAL MARKETS* 35 (Table 6) (1992).

43. See JOHNSON, *supra* note 1, at 457-59 (discussing growth in use of offshore markets by corporations).

44. *Id.* at 459. The industrialized nations developed large trade surpluses that financed investment throughout the globe. *Id.*

market technology, as well as the growing sophistication of corporate financiers, have provided the tools necessary to make international issuance and trading a reality.⁴⁵ The development of financial engineering⁴⁶ and sophisticated derivatives⁴⁷ has enabled multinational corporations to hedge⁴⁸ against fluctuations in currencies and interest rates.⁴⁹ The creation of automated clearance and settlement facilities,⁵⁰ improvements in worldwide secondary markets,⁵¹ and advances in telecommunications and computer technology has made transactions easier and trades instantaneous.⁵² Over the last decade, the increasing dominance of institutional investors⁵³ has also played an important role, as those organizations have sought new investment opportunities.⁵⁴ Today, large U.S. corporations must access offshore sources of investment to minimize their firm's cost of capital.⁵⁵

2. Offshore Issuance Procedures

Like the domestic securities markets, two types of securities are offered and sold on the international securities markets — debt, which can be either Eurobonds⁵⁶ or foreign bonds,⁵⁷ and

45. *Id.*

46. See MARSHALL & ELLIS, *supra* note 5, at 9. Financial engineering is the development and use of innovative financial products to solve financial problems, gain opportunities, and add value to a deal. *Id.*

47. See ROBERT W. HAMILTON, *MONEY MANAGEMENT FOR LAWYERS AND CLIENTS: ESSENTIAL CONCEPTS AND APPLICATIONS* 521-22 (1993). Derivatives are securities, such as options, swaps, and index futures, that derive their value from the underlying value of other securities, such as stocks, or commodities. *Id.*

48. *Id.* at 528. An investor hedges his or her position by undertaking a transaction that protects an existing holding from adverse price movements. *Id.*; see ZVI BODIE ET AL., *INVESTMENTS* 833-53 (2d ed. 1993) (discussing methods of hedging).

49. See MARSHALL AND ELLIS, *supra* note 4, at 227 (discussing reasons why derivatives are used).

50. *Id.* at 287-94. The clearing of trades is the process by which payment is collected from the buyer of securities and transferred to the purchaser of securities, and securities are delivered from the seller to the buyer. *Id.* at 287.

51. See HAMILTON, *supra* note 47, at 545. A secondary market is a market in which investors who own securities can sell them to purchasers. *Id.*

52. See JOHNSON, *supra* note 1, at 458 (discussing non-economic factors that influenced growth of offshore markets).

53. See HAMILTON, *supra* note 47, at 530. Institutional investors are large organizations that invest other people's money, such as pension or mutual funds. *Id.*

54. See JOHNSON, *supra* note 1, at 458-59.

55. See Euan Hagger, *Issuing Abroad Is A Risky Venture*, *CORP. FIN.*, Nov. 1993, at 22 (discussing benefits to corporations of using offshore funding).

56. MARSHALL & ELLIS, *supra* note 5, at 79. Eurobonds are various types of debt

equity ("Euroequity").⁵⁸ During the 1960's and 1970's, debt instruments were the primary tools of offshore finance.⁵⁹ During the 1980's a global Euroequity market was created.⁶⁰

The offshore markets work in the same manner as the domestic markets, except that they operate on a wider scale.⁶¹ Initially, a corporation that is interested in raising capital from offshore investors will approach a major investment bank⁶² for advice on how to most effectively market its securities to international investors.⁶³ Sometimes, however, an offshore offering will get its start when an investment bank approaches a company with a detailed proposal to raise capital for the firm outside of the United States.⁶⁴ If the advising bank concludes that an offshore offering⁶⁵ is feasible, it, or another investment bank, will become the lead manager⁶⁶ of the offering.⁶⁷ Once the lead

instruments sold on multiple non-domestic markets. GLOBAL BANKER, *supra* note 2, at 91. They may be denominated in any currency, but are usually denominated in U.S. dollars ("Yankee Bonds"), Japanese yen ("Samurai Bonds"), or British pounds ("Bull-dog Bonds"). MARSHALL & ELLIS, *supra* note 5, at 79.

57. MARSHALL & ELLIS, *supra* note 5, at 79. Foreign bonds are debt instruments sold in a single offshore market. *Id.*

58. See TORBEN JUUL ANDERSON, EUROMARKET INSTRUMENTS 209-63 (1990) (discussing international equity related issues). Euroequities are stocks placed and traded in nations outside the issuer's home country. *Id.* at 209. An international stock is one that is traded on several different markets. HANS STOLL, *The Shape of World Equity Markets*, in INTERNATIONAL FINANCE & FINANCIAL POLICY 225 (Hans Stoll ed., 1990).

59. Proposed Rules, 53 Fed. Reg. 22,661, 22,664 (June 17, 1988) (discussing changes in offshore capital markets over preceeding three decades). In 1983 the Euroequity market was almost non-existent. *Id.*

60. See GOLDSTEIN, *supra* note 42, at 35 (discussing expansion of Euroequity market in late 1980's and early 1990's). In the first half of 1991, international primary offerings of ordinary shares totalled nearly US\$15 billion. *Id.* at 64 (Table A17). Offshore issues of convertible bonds, which can be exchanged for stock in the issuing company upon the happening of a specific event, and bonds with equity warrants, which provide special certificates that the holder can exchange for stock, in addition to the standard rights conferred by the bond, accounted for an additional US\$24 billion. *Id.*

61. See AYLING, *supra* note 1, at 102. Although this procedure describes Eurobond issuance, the procedures used for issuing Euroequity are very similar. See ANDERSON, *supra* note 58, at 219-20 (discussing application of Eurobond syndication techniques to Euroequity issuance).

62. See *supra* note 30 and accompanying text (discussing definition of investment bank).

63. See AYLING, *supra* note 1, at 102-03 (discussing Eurobond syndication techniques).

64. *Id.*

65. See MARSHALL & ELLIS, *supra* note 5, at 78-79. An offshore offering is a primary offering to investors outside of the United States. *Id.*

66. See MARSHALL & ELLIS, *supra* note 5, at 64. The lead manager or lead under-

manager and the issuer have determined how they will structure the securities to be sold, the lead manager will seek out other investment banks ("co-underwriters" and "managers") to aid in the underwriting and distribution of the securities to individual and institutional investors.⁶⁸ The co-underwriters or managers receive a fee for their participation, along with a spread between the price they pay for the stock and the public offering price.⁶⁹ In return, they not only agree to distribute the securities to offshore investors, but also to enlist smaller local firms, called selling agents, to aid in the distribution.⁷⁰ Past multinational and global distributions have included more than ten managers and dozens of distributors.⁷¹ These participants, along with the issuing corporation, are known as the issuing group.⁷²

B. *The Purpose and Requirements of the Securities Act and the Sanctions that May Be Imposed for Failure to Register*

Approximately half of the US\$50 billion of new issues of securities⁷³ sold to the U.S. investing public during the boom mar-

writer is the investment banking firm that manages the underwriting syndicate in a public offering. *Id.*

67. AYLING, *supra* note 1, at 103.

68. *Id.* at 103. The managers become the underwriters' principals and agree to purchase the remainder of an issue in the event they are unable to sell all of the securities that have been issued. *Id.*

69. *Id.* The lead underwriter, acting as the issuer's agent, generally negotiates the fee arrangements with the other members of the underwriting syndicate. *Id.*

70. *Id.* The lead manager, in conjunction with the selling agents, develops a selling prospectus, containing financial and other business information about the issuer that is given to potential purchasers. *Id.* The selling agents publish advertisements, called tombstones, in local financial journals and newspapers, announcing the salient information regarding the securities offering in order to attract investors in their respective markets. *Id.*

71. *Id.*

72. Wolff, *supra* note 4, at 141. The "issuing group" includes the issuer, distributors, affiliates thereof, and their agents. *Id.*

73. See Jennings, *supra* note 1, at 264-317 (discussing what constitutes a security); see also Securities & Exchange Commission v. W.J. Howey, 328 U.S. 293 (1946) (discussing Howey test for determining whether a purchase agreement constitutes an investment contract, and, therefore, a security); Securities and Exchange Commission v. Koscot Interplanetary, Inc., 497 F.2d 473 (1974) (holding that rights in pyramid scheme are securities); International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America v. Daniel, 49 U.S. 551 (1979) (holding that non-contributory, compulsory pension plans are securities); Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) (holding that stock is security under Securities Act regardless of whether entire company is sold to one purchaser); Reves v. Ernst & Young, 494 U.S. 56 (1990) (holding that certain demand notes issued by a farmer's cooperative are securities).

ket of the 1920's later proved to be worthless.⁷⁴ After the crash of the U.S. stock markets in 1929,⁷⁵ the U.S. Congress came to believe that unscrupulous securities underwriters⁷⁶ and dealers⁷⁷ had perpetrated a massive fraud on the investing public.⁷⁸ Franklin D. Roosevelt, following his inauguration as President of the United States, proposed that the U.S. Congress pass legislation regulating the offer and sale of securities on the U.S. public markets.⁷⁹ The Securities Act of 1933 was the result.⁸⁰

The Securities Act demands that issuers of corporate securities make full disclosure of material facts related to a primary offering⁸¹ unless the offering qualifies for an exemption from registration.⁸² The goal of the act is to protect unsophisticated

For the purposes of this Note, it is sufficient to define security to include notes, stocks, bonds, and debentures. See Securities Act of 1933 § 2(1) (discussing statutory definition of security).

74. H.R. Rep. No. 85, 73rd Cong., 1st Sess. 2 (1933) (discussing fraudulent practices in U.S. stock markets during years between World War I and Great Depression).

75. See generally BARRIE A. WIGMORE, *THE CRASH & ITS AFTERMATH: A HISTORY OF SECURITIES MARKETS IN THE UNITED STATES, 1929-33* (1985).

76. See MARSHALL & ELLIS, *supra* note 5, at 57-86 (discussing the definition of underwriter and underwriting process). Underwriters have three primary tasks. *Id.* at 57. First, they originate deals. *Id.* Origination consists of the development of the terms and registration of a securities offering. *Id.* Second, they underwrite securities. *Id.* Underwriting is the purchase of securities from an issuer, for sale to the public. *Id.* Finally, they distribute, or sell, the securities to the public. *Id.*

77. *Id.* at 108-09. A dealer buys and sells securities as a principal, and makes his or her money from the spread between what he or she pays for the securities and the price at which he or she sells those securities. *Id.*

78. See H.R. Rep. No. 85, 73rd Cong., 1st Sess. 2 (1933). The congressional report reads in pertinent part as follows:

The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were made with little or no attempt to bring to the investors attention those facts essential to estimating the worth of any security.

Id. at 2.

79. See H.R. Doc. No. 12, 73rd Cong., 1st Sess. (1933) [hereinafter MESSAGE FROM THE PRESIDENT OF THE UNITED STATES] (discussing underlying purposes of Securities Act).

80. Securities Act of 1933, 15 U.S.C. § 77a-77z (1988 & Supp. V 1993).

81. *Id.* § 5. Section 5 makes it unlawful for any person to use the means of interstate commerce to sell, or offer to sell, non-exempt, unregistered securities. *Id.*

82. *Id.* § 4. The two most important statutory exemptions for the purpose of this Note state as follows:

The provisions of section 5 shall not apply to—

(1) transactions by any person other than an issuer, underwriter, or dealer.

U.S. investors from being misled by issuers, distributors, and dealers of securities.⁸³ It attempts to achieve this aim by ensuring that corporate securities issuers provide the investing public with all information necessary to make informed investment decisions.⁸⁴ The disclosure rules are not intended to prevent investors from making unwise investment decisions.⁸⁵ Rather, they attempt only to guarantee that investors have the opportunity to review pertinent information before they purchase securities.⁸⁶

1. Registration Requirements

The centerpiece of the Securities Act is Section 5,⁸⁷ which states that no security shall be offered or sold unless it is registered with the SEC.⁸⁸ An issuer registers a primary offering of securities by filing a registration statement with the Commission.⁸⁹ The registration statement consists of two documents: the prospectus,⁹⁰ which must be given to every purchaser of the

(2) transactions by an issuer not involving any public offering.

Id. These two exemptions are termed the non-underwriter and private placement exemptions. See Jennings, *supra* note 1, at 322-76, 459-523 (discussing private placement and non-underwriter exemptions).

83. S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933). In its report to the U.S. Senate, the Committee on Banking and Currency stated that "[t]he basic policy of [the Securities Act] is that of . . . providing protection against fraud and misrepresentation." *Id.*

84. H.R. Doc. No. 12, 73d Cong., 1st Sess. (1933). In his address to Congress, President Franklin Delano Roosevelt stated that "every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and . . . no essentially important element attending the issue shall be concealed from the buying public." *Id.* The Securities Act takes the premise that public companies are public bodies and its managers public functionaries. ROBERTA S. KARMEL, REGULATION BY PROSECUTION 41 (1982). The Supreme Court has defined the Securities Act as legislation that substitutes a philosophy of full disclosure in securities issuance for the "buyer beware" model. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

85. See LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 25-35 (1988) (discussing history of U.S. debate over securities regulation). Congress did not take away the investor's right to "make a fool of himself." *Id.* at 33. It only attempted to lessen the likelihood that others would make fools of investors. *Id.*

86. See KARMEL, *supra* note 84, at 40-42 (discussing U.S. Congress' purpose in adopting Securities Act); see also MESSAGE FROM THE PRESIDENT OF THE UNITED STATES, *supra* note 82, at 1. U.S. President Franklin D. Roosevelt stated that "the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit." *Id.*

87. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1988 & Supp. V 1993).

88. *Id.*

89. *Id.* § 7(a).

90. Securities Act of 1933 § 2(10). Section 2(10) defines prospectus as follows: The term "prospectus" means any prospectus, notice, circular, advertisement,

securities,⁹¹ and a second part, which contains information that need not be distributed to purchasers, but is kept in a public file by the SEC.⁹² Schedule A of the Securities Act prescribes the basic contents of the registration statement.⁹³ Until the registration statement becomes effective,⁹⁴ the issuer cannot sell its securities to the public.⁹⁵ The registration statement becomes effective either on a date authorized by the SEC, twenty days after filing,⁹⁶ or, if the SEC issues a stop order,⁹⁷ once the stop order is lifted.⁹⁸ Issuers who do not comply with the registration procedures prescribed by the Securities Act are subject to a variety of civil and criminal sanctions.⁹⁹

letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except that (a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 10) shall not be deemed a prospectus if it is proved prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 10 at the time of such communication was sent or given to the person to whom the communication was made, and (b) a notice, circular, advertisement letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of Section 10 may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to terms and conditions as may be prescribed therein, may permit.

Id.; see *id.* § 10 (discussing information required in prospectus).

91. *Id.* § 5(b).

92. See Regulation C — Registration, 17 C.F.R. 230.400-230.495 (1994) (discussing SEC requirements for effective registration under Securities Act).

93. Securities Act of 1933, sched. A.

94. See JENNINGS, *supra* note 1, at 251. An effective registration statement is one which has been formally approved for distribution to the public by the SEC. *Id.*

95. See Securities Act of 1933 § 8 (discussing effectiveness of registration statements and amendments thereto).

96. *Id.* § 8(a).

97. *Id.* § 8(d). The Securities Act defines a stop order as an order which, after the filing of a registration statement, suspends the effectiveness of such registration statement until such time as the contents of the registration statement have been amended in accordance with SEC requirements. *Id.*

98. *Id.*

99. See *id.* §§ 8A, 11, 20 (discussing sanctioning power of SEC and private remedies available to purchasers in regard to unregistered securities).

2. Private Remedies

Under Section 12(1) of the Securities Act,¹⁰⁰ purchasers of unregistered securities may sue for return of the consideration paid, upon return of the securities to the seller, or damages, if the securities have already been sold.¹⁰¹ In order to recover, the purchaser need only prove that the defendant sold the securities to him and that they were not registered.¹⁰² A successful claim shifts the burden to the defendant to demonstrate the availability of an exemption from registration.¹⁰³ A purchaser, however, can generally sue only the person from whom he bought the securities, or a person who solicits the purchase for his own financial purposes or those of the seller.¹⁰⁴ Thus an issuer who sells unregistered securities to an underwriter for resale is not directly liable to the individual investor.¹⁰⁵

3. The Investigatory and Sanctioning Powers of the SEC

U.S. securities laws grant the SEC authority to investigate alleged violations of the Securities Act registration requirements.¹⁰⁶ If, after investigating, the Commission determines that

100. *Id.* § 12. Section 12 of the Securities Act states in pertinent part as follows:
Any person who—

(1) offers or sells a security in violation of section 5 . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Id.

101. *Id.*

102. Ralph C. Ferrara & Andrea Robinson, *The Development of Express and Implied Remedies Under The Securities Act of 1933 and The Securities Exchange Act of 1934*, at 7-8, in *INTRODUCTION TO LITIGATION OF DISPUTES AFFECTING THE U.S. AND THE U.K.* 409, 429-30 (PLI Corp. L. and Practice Course Handbook Series No. B4-6796, 1987). A seller who violates the 1933 Act's registration requirements is strictly liable to purchasers under Section 12(1). *Id.*; see Securities Act of 1933 § 12(1) (granting private remedy of rescission or damages to purchasers against for failure of an issuer to register securities).

103. *Id.* A seller of unregistered securities is strictly liable to his or her buyer. *Id.*

104. *Pinter v. Dahl*, 486 U.S. 622, 655 (1988).

105. See *Collins v. Signetics*, 605 F.2d 110 (3d Cir. 1979). Recently, a number of courts have reduced the efficacy of this private remedy by holding that Section 12 applies only to initial distributions, and cannot be used to impose liability on brokers for their recommendations. See, e.g., *Ballay v. Legg Mason*, 925 F.2d 682 (3d Cir. 1991) (holding that brokers may not be liable under § 12(2) for facilitating sales using materially false registration statements).

106. Securities Exchange Act of 1934 § 21. Section 21(a)(1) provides as follows:
The Commission may, in its discretion, make such investigations as it deems

a violation has occurred or is about to occur, it may take one of three actions against the alleged violator.¹⁰⁷ First, it may order an administrative hearing to ascertain who is liable, and to issue cease and desist orders.¹⁰⁸ Second, the Commission may bring an action in federal court to enjoin violations of the registration requirements¹⁰⁹ or to seek civil penalties.¹¹⁰ Third, the SEC may transmit evidence of willful violations of Section 5 and its subsidiary rules to the U.S. Justice Department, which may decide to undertake a criminal prosecution.¹¹¹ These willful violations are

necessary to determine whether any person has violated, is violating, or is about to violate any provision under this title, the rules or regulations thereunder . . . and may require or permit any person to file with it a statement in writing, under oath . . . as to all the facts and circumstances concerning the matter to be investigated.

Id. Section 20(a) of the Securities Act of 1933 provides as follows:

Whenever it shall appear to the Commission, either upon complaint or otherwise, that the provisions of this title, or of any rule or regulation prescribed under authority thereof, have been or about to be violated, it may, in its discretion, either require or permit such person to file with it a statement in writing, under oath, or otherwise, as to all the facts and circumstances concerning the subject matter which it believes to be in the public interest to investigate, and may investigate such facts.

Securities Act of 1933 § 20.

107. *See id.* §§ 8A, 20(b)-(c) (discussing power of SEC to seek sanctions for failure of issuer to register securities).

108. *Id.* § 8A. The Commission may issue a cease and desist order, after giving notice and an opportunity to be heard, to any person who is violating, has violated, or is about to violate § 5. *Id.*

109. *Id.* § 20.

110. *Id.* If the SEC uncovers an alleged violation of § 5, it may, under § 20(d), "bring an action in a United States district court to seek . . . a civil penalty to be paid by the person who committed such violation." *Id.* Innocent failures to register are punishable by the greater of fines of up to US\$5000 for a natural person and up to US\$50,000 for any other person, or the gross monetary gain to such violator as a result of the violation. *Id.* § 20(d)(2)(A). Fraudulent, deceptive, or manipulative failures to register are punishable by fines that do not exceed the greater of either US\$50,000 for natural persons and US\$250,000 for any other person, or the gross amount of monetary gain to the violator as a result of the violation. *Id.* § 20(d)(2)(B). Fraudulent, deceptive, or manipulative failures to register that result in substantial losses or create a significant risk of financial losses to other persons are punishable by fines that do not exceed the greater of US\$100,000 for natural persons and US\$500,000 for any other person, or the gross amount of monetary gain to the violator due to the violation. *Id.* § 20(d)(2)(C).

111. *Id.* § 20(b). Section 20(b) states in pertinent part as follows:

The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General who may, in his discretion, institute the necessary criminal proceedings under this title. Any such criminal proceeding may be brought either in the district wherein the transmittal of the prospectus or security complained of begins, or in the district wherein such security or prospectus is received.

punishable by fines and imprisonment.¹¹²

C. SEC Regulation of Offshore Transactions Prior to Regulation S

The SEC's position concerning the applicability of the Securities Act¹¹³ registration requirements to offshore transactions has evolved with the growth of the offshore markets.¹¹⁴ During the thirty years following the adoption of the Securities Act, the SEC viewed the securities laws as a protective shield that applied to U.S. citizens, residents, and corporations both within and without the United States.¹¹⁵ One result of this approach was that U.S. investors were largely unable to participate in the offshore markets due to issuers' fears that the presence of a U.S. citizen, resident, or corporation in an international offering would force them to comply with the Securities Act registration requirements.¹¹⁶ In 1963, the U.S. government, facing a balance of payments deficit, recognized the need for the SEC to make it easier for U.S. corporations to raise capital overseas.¹¹⁷ Responding to the recommendations of the Presidential Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad,¹¹⁸ the SEC promulgated Securities Release 4708 ("Release 4708").¹¹⁹

Id.

112. *Id.* § 24. Section 24 states in pertinent part as follows: "Any person who willfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under the authority thereof, . . . shall upon conviction be fined not more than \$10,000 or imprisoned not more than five years, or both." *Id.*

113. Securities Act of 1933, 15 U.S.C. §§ 77a-77z (1988 & Supp. V 1993).

114. See Joseph A. Grundfest, *Zen and the Art of Securities Regulation*, in *MODERNIZING U.S. SECURITIES REGULATION: ECONOMIC AND LEGAL PERSPECTIVES* 3, 10 (Kenneth Lehn & Robert W. Kamphuis, Jr. eds., 1992) (discussing changes in SEC approach as result of internationalization of securities markets).

115. Kellye Y. Testy, *Comity and Cooperation: Securities Regulation in a Global Marketplace*, 45 ALA. L. REV. 927, 940 (1994); see JOHNSON, *supra* note 1, at 469 (discussing SEC prohibition of any non-exempt sales of unregistered securities to U.S. citizens and residents prior to Regulation S).

116. Testy, *supra* note 115, at 941 (discussing restraints on U.S. investor participation in offshore markets prior to adoption of Regulation S).

117. Registration of Foreign Offerings by Domestic Issuers; Registration of Underwriters of Foreign Offerings as Broker-Dealers, Securities Act Release No. 4708 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 1361, 1964 WL 3661 (SEC), at 1 (July 9, 1964) [hereinafter Release 4708].

118. *Id.*

119. *Id.* Section 19(a) of the Securities Act grants the SEC the power to issue, amend and repeal rules and regulations relating thereto. Securities Act of 1933 § 19,

Release 4708 officially reiterated the SEC's previous position that the Securities Act registration requirements were primarily intended to protect U.S. investors.¹²⁰ Having analyzed various statutory exemptions contained in the Securities Act,¹²¹ the SEC, in Release 4708, stated that the Securities Act registration requirements would not apply to offshore offerings, even if the means of U.S. interstate commerce were used,¹²² as long as the offering was made outside the United States to non-U.S. persons¹²³ in a manner that would ensure that the securities would come to rest abroad.¹²⁴ The purpose of the coming to rest

15 U.S.C. § 77s (1988 & Supp. V 1993). Section 19 states as follows: "(a) The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this title The rules and regulations shall be effective upon publication in the manner which the Commission shall prescribe." *Id.*

120. *Id.*

121. See *supra* note 82 and accompanying text (discussing and defining statutory exemptions from Securities Act registration requirements).

122. Release 4708, Fed. Sec. L. Rep. (CCH) ¶ 1361, at 1362. Section 5 of the Securities Act of 1933 makes it illegal to use the means of interstate commerce to sell unregistered securities. Securities Act of 1933 § 5. Because interstate commerce was defined broadly under Release 4708, the registration requirements could have been held to apply to deals having a minimal nexus to the United States, such as a telephone call. Testy, *supra* note 115, at 939.

123. Proposed Rules, 53 Fed. Reg. 22,661, 22,663 (June 17, 1988). Under Release 4708, the SEC staff defined the term "U.S. person" in much broader fashion than it is defined in Regulation S. *Id.* It included all U.S. residents and citizens, whether at home or abroad, and organizations formed under the laws of the United States or any of its political subdivisions. See, e.g., Goldman Sachs & Co., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2578 (Oct. 3, 1985) (discussing definition of U.S. person under Release 4708). Under Regulation S, a U.S. person includes natural persons resident in the U.S., U.S. partnerships or corporations, U.S. estates, U.S. trusts, agencies and branches of foreign entities located in the U.S., and U.S.-based securities accounts. Regulation S, 17 C.F.R. § 230.902(o) (1994).

124. See Release 4708, Fed. Sec. L. Rep. (CCH) ¶ 1361, at 1363. The requirement that securities come to rest abroad was not defined in Release 4708. Testy, *supra* note 115, at 940. Instead, over a period of years, the SEC developed a set of procedures through no-action letters to determine when the securities would be deemed to have come to rest abroad. Proposed Rules: Offshore Offers and Sales, 53 Fed. Reg. 22,661, 22,662-63 (1988). Restrictions on the resale of debt securities included a 90 day period following completion of the distribution during which no sales could be made in the United States or to U.S. persons. Proctor & Gamble Co., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 1870 (Feb. 21, 1985). Restrictions on equity securities were substantially more stringent. Proposed Rules: Offshore Offers and Sales, 53 Fed. Reg. 22,661, 22,662 (1988). The InfraRed Associates no-action letter provided a restricted period of twelve months, as well as a number of other procedures that came to form the basis of Regulation S. InfraRed Associates, Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2617 (Oct. 14, 1985).

abroad doctrine was to limit flowback¹²⁵ of unregistered securities into the United States.¹²⁶

Although Release 4708 specified two types of offshore securities transactions that would continue to require registration under the Securities Act,¹²⁷ it did not enumerate clear guidelines that U.S. companies could follow to ensure that their securities would come to rest abroad.¹²⁸ Due to this lack of clarity, over the twenty-five years following the promulgation of Release 4708, the SEC received a flood of requests for no-action letters¹²⁹ from U.S. issuers who wished to offer and sell their securities abroad.¹³⁰ The no-action letters allowed individual issuers to determine whether the steps that they planned to take to ensure that their unregistered securities would come to rest abroad¹³¹ would satisfy SEC requirements.¹³² During this period, the body of no-action letters that were issued detailed a variety of procedures that could be adopted by U.S. issuers to ensure compliance with the Release.¹³³

Despite the availability of more than twenty years of no-action letters, in the late-1980's many U.S. companies continued to

125. Testy, *supra* note 115, at 940.

126. See Adopting Release, 55 Fed. Reg. 18,306, 18,308 (May 2, 1990) (discussing SEC approach to offshore application of Securities Act registration requirements under Release 4708). Under Release 4708, the SEC staff refused to state what conditions would allow securities issued pursuant to Release 4708 to be resold in the United States or to U.S. persons. *Id.* Instead, the staff continually stated that resales could only be made if the securities were registered or qualified for an exemption from registration. *Id.*

127. See Release 4708, *supra* note 117, at 2. Release 4708 stated that distributions of U.S. corporate securities through the facilities of Canadian stock exchanges and public offerings specifically directed towards U.S. nationals abroad would always be subject to registration. *Id.*

128. See Testy, *supra* note 115, at 939 (discussing lack of clarity of Release 4708).

129. See JENNINGS, *supra* note 1, at 101-02 (discussing SEC administrative procedures). A no-action letter is a letter, written by the staff of the SEC, in response to a request from the attorney of an issuer or investor. *Id.* at 101. If the staff of the SEC agrees with the attorney's interpretation, the no-action letter will state that the staff will not recommend any enforcement action if the attorney's client adheres to the procedures and facts discussed in the attorney's letter. *Id.* No-action letters are available to the public. *Id.* They do not, however, bind the Commission, which has overruled no-action letters in the past. *Id.*

130. Berger, *supra* note 4, at 580-81.

131. See *supra* note 124 (discussing concept of securities coming to rest abroad).

132. Adopting Release, 55 Fed. Reg. 18,306, 18,308 (May 2, 1990).

133. See *supra* note 124-26 and accompanying text (discussing procedures adopted through no-action process to ensure that offshore distributions would come to rest abroad).

find it necessary to protect themselves from sanctions by requesting their own determinations from the SEC.¹³⁴ The costs and length of time necessary to resolve these uncertainties continued to limit the ability of U.S. corporations to raise capital overseas.¹³⁵ The SEC, therefore, found its human resources overtaxed by the growth and internationalization of the securities markets.¹³⁶ In recognition of the increasing involvement of U.S. issuers and investors in the international markets,¹³⁷ the Commission, as part of an overall re-evaluation of its regulatory structure,¹³⁸ decided to standardize the procedures that corporations could follow to legally issue unregistered, non-exempt securities outside of the United States.¹³⁹

134. See, e.g., Proctor & Gamble Co., SEC No-Action Letter, 1985 WL 53956 (Feb. 21, 1985); see also Pan American World Airways, Inc., SEC No-Action Letter, 1975 WL 11264 (May 28, 1975).

135. Wolff, *supra* note 4, at 112-13. A number of commentators claimed that Release 4708 increased the cost of capital for U.S. issuers who chose to access the offshore markets. See, e.g., SEC Releases Proposals on International Transactions, 20 Sec.Reg. & L.Rep. (BNA) No. 24, at 912 (June 17, 1988) (discussing increased cost of capital for U.S. issuers under Release 4708).

136. See Grundfest, *supra* note 114, at 3 (discussing future of U.S. securities regulation). The increasing ability of issuers and investors to find substitutes for the U.S. markets meant that new SEC rules would have to be more sensitive to changes in the markets than they were in the past. *Id.* at 4.

137. Andreas J. Roquette, *New Developments Relating to the Internationalization of the Capital Markets: A Comparison of Legislative Reforms in the United States, the European Community, and Germany*, 14 U. PA. J. INT'L BUS. L. 565 (1994). Recently, there has been a significant increase in the number of U.S. investors trading in non-U.S. securities and the number of U.S. companies issuing securities overseas. *Id.*

138. See Grundfest, *supra* note 114, at 9-10 (discussing value of regulatory diversity). This re-evaluation began with the 1982 adoption of Regulation D, which restructured the private placement rules. Regulation D — Rules Governing the Limited Offer and Sales of Securities Without Registration Under the Securities Act, 17 C.F.R. §§ 230.501-230.508 (1994); see JOHNSON, *supra* note 1, at 336-48 (discussing procedures of Regulation D). Another early example of this restructuring was the adoption of Rule 415, which eased restrictions on shelf registration of new issues by reporting companies. Delayed or Continuous Offering and Sale of Securities, 17 C.F.R. § 230.415 (1994); see JOHNSON, *supra* note 1, at 377-415 (discussing shelf-registration procedures). Additionally, at the same time as Regulation S was adopted, the SEC adopted Rule 144A, which provided an exemption from registration for securities sold to sophisticated institutional investors. Private Resales of Securities to Institutions, 17 C.F.R. § 230.144A (1994) [hereinafter Rule 144A]; see JOHNSON, *supra* note 1, at 353-57 (discussing procedures of Rule 144A).

139. Bevis Longstreth et al., *Regulation S and Rule 144A: Has the SEC Got It Right?*, INT'L FIN. L. REV., Sept. 1989, at 30. Regulation S is designed to provide guidance and certainty for offshore issuers. *Id.* Although Regulation S has codified guidelines for the offshore exemption, some commentators have argued that it is not as clear as the SEC originally intended. Kelley & Bannister, *supra* note 11, at 166.

D. *The Regulation S Approach*

On April 23, 1990, after three years of research, analysis, and discussion by and between the Commission, major investment banks, law firms, and corporate financial executives,¹⁴⁰ the SEC replaced Release 4708 with Regulation S.¹⁴¹ The adoption of Regulation S represented a revolutionary change in the SEC's approach to the extraterritorial application of the Securities Act.¹⁴² Unlike Release 4708, which severely restricted sales to U.S. persons, Regulation S takes a geographic approach to the application of the Securities Act registration requirements.¹⁴³ Consequently, the availability of Regulation S is not predicated on whether the securities are offered and sold to a U.S. person, but on whether the offer and sale is made outside of the United States or its territories.¹⁴⁴

1. The Structure of Regulation S

Regulation S went into effect on May 2, 1990.¹⁴⁵ It consists of four rules, introduced by seven preliminary notes that limit the scope of the regulation.¹⁴⁶ Rule 901 contains a general state-

140. See Proposed Rules, 53 Fed. Reg. 22,661 (June 17, 1988) (discussing initial proposal for Regulation S); Proposed Rules, 54 Fed. Reg. 30,063 (July 18, 1989) (discussing second proposal for Regulation S); Adopting Release, 55 Fed. Reg. 18,306 (May 2, 1990) (discussing Regulation S as adopted).

141. Regulation S—Rules Governing Offers and Sales Made Outside of the United States Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.901-230.904 (1994).

142. Edward F. Greene, *Reproposed SEC Rule 144A*, in 21ST ANNUAL INSTITUTE ON SECURITIES REGULATION, at 43 (PLI Corp. L. & Practice Course Handbook Series No. 662, 1990). At the symposium, Greene, an SEC Commissioner, stated that he believed that both Regulation S and Rule 144A represented a revolution in the SEC's approach to the Securities Act of 1933. *Id.* Whereas prior to the adoption of Regulation S the SEC prohibited the offer and sale of unregistered securities to U.S. citizens, residents, or corporations by any corporation, Regulation S has, in many instances, made it legal for U.S. persons to purchase securities in offshore primary and secondary markets. Wolff, *supra* note 4, at 105.

143. Adopting Release, 55 Fed. Reg. 18,306, 18,308. The regulation takes a territorial, rather than citizenship, approach to § 5 of the Securities Act. *Id.* Unlike Release 4708, which sought to protect U.S. purchasers worldwide, Regulation S seeks only to protect U.S. capital markets and those purchasing on them. *Id.* Therefore, as long as the offers and sales take place outside of the United States, they are exempt from Section 5 even if the securities are sold to U.S. citizens. Berger, *supra* note 4, at 581.

144. Berger, *supra* note 4, at 581.

145. Adopting Release, 55 Fed. Reg. 18,306, 18,306.

146. See 17 C.F.R. §§ 230.901-230.904, prelim. notes (discussing applicability of Regulation S).

ment of applicability.¹⁴⁷ Rule 902 provides definitions for many of the terms used in Regulation S.¹⁴⁸ Rules 903¹⁴⁹ and 904¹⁵⁰ provide safe harbor guidelines.¹⁵¹

2. The General Statement of Regulation S

Under Release 4708,¹⁵² the SEC took the position that issuers could not sell unregistered securities to U.S. persons regardless of where in the world they resided.¹⁵³ In contrast, the general policy of Regulation S, contained in Rule 901, specifies that the registration requirements of the Securities Act of 1933 are not applicable to any offshore securities transactions.¹⁵⁴ Consequently, the regulation lays out extensive parameters for ascertaining whether a distribution takes place outside of the United States.¹⁵⁵

3. The Safe Harbor Concept

Rules 903 and 904 provide safe harbors, adherence to which by offshore issuers and sellers of unregistered securities ensures that registration under the Securities Act is not required.¹⁵⁶ The

147. 17 C.F.R. § 230.901. Rule 901 states that the registration requirements shall not be applicable to any securities transaction that takes place outside of the United States. *Id.*

148. 17 C.F.R. § 230.902. Rule 902 provides definitions for most of the important terms used in Regulation S, including Designated Offshore Securities Market, Directed Selling Efforts, Distributor, Domestic Issuer, Foreign Government, Offering Restrictions, Offshore Transaction, Overseas Directed Offering, Reporting Issuer, Restricted Period, and U.S. Person. *Id.*

149. 17 C.F.R. § 230.903.

150. 17 C.F.R. § 230.904.

151. *See* Adopting Release, 55 Fed. Reg. 18,306, 18,315-20 (May 2, 1990) (discussing the procedures of issuer and resale safe harbors). A safe harbor is defined as a set of guidelines in the federal securities regulations that, if followed, give issuers and their agents protection from sanctions. *See* Jennings, *supra* note 1, at 1595 (discussing Regulation S safe harbors).

152. Release 4708, *supra* note 117, at 1.

153. *See* Wolff, *supra* note 4, at 105.

154. 17 C.F.R. § 230.901. Rule 901 states as follows:

For the purposes only of Section 5 of the Act [15 U.S.C. § 77e], the terms "offer," "offer to sell," "sell," "sale," and "offer to buy" shall be deemed to include offers and sales that occur within the United States and shall be deemed not to include offers and sales that occur outside the United States.

Id.

155. Berger, *supra* note 4, at 581. Rule 902(p) defines "United States" as the United States of America, its territories and possessions, any State and the District of Columbia. 17 C.F.R. § 230.902(p).

156. *See* BUREAU OF NATIONAL AFFAIRS, CORPORATE PRACTICE SERIES LEAFLET NO.

SEC adopted a territorial approach¹⁵⁷ to these safe harbors for three reasons.¹⁵⁸ First, the Commission, having accepted the principle of international comity, determined that offshore distributions of securities that are regulated under the securities laws of another nation need not be governed by the Securities Act.¹⁵⁹ Second, the SEC discovered that the use of territorially-based safe harbors would best enable the Commission to standardize the procedures necessary to limit the possibility of flowback of Regulation S securities into the United States.¹⁶⁰ Third, the Commission concluded that because U.S. investors have significant access to information concerning reporting issuers,¹⁶¹ some flowback of reporting issuers' securities would not harm U.S. investors.¹⁶² The ability of offshore investors to easily resell securities outside of the United States without registration under the Securities Act is essential to the SEC's goal of improving U.S. corporate access to international capital.¹⁶³ By adopting a geographic approach to the safe harbors, Regulation S allows routine trading of unregistered U.S. corporate securities on the offshore secondary markets¹⁶⁴ once the issuers' international

58. REGULATION S: THE SAFE HARBOR FOR OFFSHORE SECURITIES TRANSACTIONS (1991) [hereinafter CORPORATE PRACTICE LEAFLET]. Although these safe harbors apply to both U.S. and non-U.S. issuers, this Note does not examine the provisions relating to distributions by non-U.S. issuers.

157. See *supra* notes 142-44 and accompanying text (discussing SEC adoption of territorial approach).

158. See Proposed Rules, 53 Fed. Reg. 22,661, 22,665 (June 17, 1988) (discussing three propositions underlying creation of Regulation S safe harbors).

159. *Id.* The principle of comity is defined as the willingness of one sovereign to recognize the laws of another either within its borders or as regards its citizens, not as a matter of right, but out of deference and good will. BLACK'S LAW DICTIONARY 267 (6th ed. 1990). The SEC has stated that principles of comity and the reasonable expectations of offshore market participants justify the position implicit in Regulation S that the laws of the countries in which the transactions take place, rather than U.S. laws, should apply to those transactions. Adopting Release, 55 Fed. Reg. 18306, 18308 (May 2, 1990). An investor who chooses to participate in markets outside of the United States chooses the law of those markets. *Id.*

160. See Proposed Rules, 53 Fed. Reg. 22,661, 22,665 (discussing SEC duty to protect U.S. investors against flowback).

161. Regulation S, 17 C.F.R. § 230.902(l) (1994). A reporting issuer is one, other than an investment company regulated by the Investment Company Act of 1940, that is already subject to the disclosure requirements of the Securities Exchange Act at the time it undertakes a Regulation S offering. *Id.*

162. See Adopting Release, 55 Fed. Reg. 18,306, 18,315 (discussing SEC acceptance of limited amount of flowback of Category Two securities).

163. See Wolff, *supra* note 4, at 112-17 (discussing history of Regulation S).

164. See *supra* note 51 and accompanying text (defining secondary markets).

marketing efforts and distribution have terminated.¹⁶⁵

a. General Conditions

Regulation S mandates that all offers and sales of unregistered securities by U.S. companies comply with two general restrictions.¹⁶⁶ First, the offer and sale must be made in an offshore transaction.¹⁶⁷ Rule 902(i) defines the term offshore transaction in a manner that places the focus of the requirement on the location of the buyer.¹⁶⁸ Second, no directed selling efforts may be made in the United States.¹⁶⁹ Rule 902(b) defines

165. See Proposed Rules, 53 Fed. Reg. 22,661, 22,665 n.63 (discussing lessening of differences between sales on offshore primary and secondary markets).

166. 17 C.F.R. §§ 230.903(a), 230.904(a).

167. *Id.*

168. 17 C.F.R. § 230.902(i). Rule 902(i) defines "offshore transaction" as follows:

(1) An offer or sale of securities is made in an "offshore transaction" if:

(i) The offer is not made to a person in the United States; and

(ii) Either:

(A) At the time the buy order is originated, the buyer is outside the United States, or the seller and any person acting on its behalf reasonably believe that the buyer is outside the United States; or

(B) For the purposes of:

(1) Section 230.903, the transaction is executed in, on or through a physical trading floor of an established foreign securities exchange that is located outside of the United States; or

(2) Section 230.904, the transaction is executed in, on or through the facilities of a designated offshore securities market described in paragraph (a) of this section, and neither the seller nor any person acting on its behalf knows that the transaction has been pre-arranged with a buyer in the United States.

(2) Notwithstanding paragraph (i) (1) of this section, offers and sales of securities specifically targeted at identifiable groups of U.S. citizens abroad, such as members of the U.S. armed forces serving overseas, shall not be deemed to be made in "offshore transactions."

(3) Notwithstanding paragraph (i) (1) of this section, offers and sales of securities to persons excluded from the definition of "U.S. person" pursuant to paragraph (o) (7) of this section or persons holding accounts excluded from the definition of "U.S. person" pursuant to paragraph (o) (2) of this section, solely in their capacities as holders of such accounts, shall be deemed to be made in "offshore transactions."

Id.

169. 17 C.F.R. § 230.903(b). For the purposes of the issuer safe harbor, "[n]o directed selling efforts shall be made in the United States by the issuer, a distributor, any of their respective affiliates, or any person acting on behalf of the foregoing." *Id.* For the purposes of the resale safe harbor, "[n]o directed selling efforts shall be made in the United States by the seller, an affiliate, or any person acting on their behalf." 17 C.F.R. § 230.904(b).

the term directed selling efforts.¹⁷⁰ Publication of information in the United States concerning a reporting issuer¹⁷¹ that is not specifically related to the offshore distribution will not be deemed to be a directed selling effort.¹⁷² The SEC has interpreted directed selling efforts in this manner in order to ensure that reporting Regulation S issuers do not lose their safe harbor protection due to incidental distribution of information within the United States, or by complying with U.S. or non-U.S. disclosure laws.¹⁷³ If a transaction meets the conditions, it can qualify for the following specific safe harbors.¹⁷⁴

170. 17 C.F.R. § 230.902(b)(1). Rule 902(b)(1) defines "directed selling efforts" as

any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on this Regulation S. Such activity includes placement of an advertisement in a publication with a general circulation in the United States that refers to the offering of securities being made in reliance upon this Regulation S.

Id. Distribution of information about, opinions on, or recommendations of the securities in the United States may constitute directed selling efforts depending on the facts. CORPORATE PRACTICE LEAFLET, *supra* note 156, at A-6.

171. *See supra* note 161 and accompanying text (discussing Regulation S definition of reporting issuer).

172. Adopting Release, 55 Fed. Reg. 18,306, 18,312 (May 2, 1990). Generally, the dissemination of routine information by reporting issuers that is not related to the securities selling effort, such as advertising and corporate communication, will not be deemed a "directed selling effort" under Regulation S. *Id.* Because publication of information by non-reporting issuers can have a substantial effect on the demand for its securities, distributors of securities of non-reporting issuer securities and their affiliates must exercise extreme caution when disseminating information in order to avoid falling afoul of the prohibition against "directed selling efforts." *Id.* at 18,311. Furthermore, legitimate selling activities carried out in the United States in connection with a registered offering made in conjunction with the Regulation S offering or an exempt unregistered offering, will not cause the issuer to violate the restriction against "directed selling efforts." *Id.* at 18,312. The SEC believes that this interpretation is justified because dissemination of information about reporting issuers has less effect on the market than dissemination of information about non-reporting issuers. *See Testy, supra* note 115, at 945-47 (discussing SEC definition of "directed selling efforts").

173. *See* Adopting Release, 55 Fed. Reg. 18,306, 18,310-312 (discussing SEC interpretation of "directed selling efforts"). For example, an advertisement placed in a U.S. publication will not be deemed a "directed selling effort" if it is mandated by U.S. law, as long as the advertisement includes a statement that the securities offered for sale are unregistered. *Id.* The SEC has long maintained the position that prohibitions on "directed selling efforts" are not meant to prohibit normal communications between issuers and their shareholders. Securities Act Release No. 5009, 34 Fed. Reg. 16,870 (Oct. 7, 1969).

174. *See* Adopting Release, 55 Fed. Reg. 18,306, 18,314 (discussing reliance on Category One safe harbor based solely on compliance with general conditions); *id.* at

b. Specific Safe Harbors

i. Issuer Safe Harbor Procedures

In order to regulate offshore primary offerings,¹⁷⁵ Rule 903 divides the issuer safe harbor into three categories.¹⁷⁶ Category One applies only to non-U.S. issuers.¹⁷⁷ Category Two applies to reporting issuers,¹⁷⁸ and certain securities issued by non-reporting, non-U.S. issuers.¹⁷⁹ Category Three covers the securities of all other issuers.¹⁸⁰

The SEC has taken this categorization approach in recognition of two facts. First, the likelihood of misuse of the offshore exemption and flowback of securities distributed thereunder varies depending on the type of issuer and security.¹⁸¹ Second, investors in unregistered securities issued by reporting issuers¹⁸² retain the protection of the Exchange Act periodic reporting requirements.¹⁸³ As a result, Regulation S prescribes fewer restric-

18,315 (discussing applicability of general conditions to Category Two safe harbor); *id.* at 18,318 (discussing applicability of general conditions to Category Three safe harbor).

175. See MARSHALL & ELLIS, *supra* note 5, at 60. There are two types of primary offerings: the Initial Public Offering ("IPO"), which is an offering of securities to the public for the first time, and the Public Offering, which is a flotation of new securities by an issuer with existing publicly traded securities. *Id.*

176. Regulation S, 17 C.F.R. §§ 230.903(c)(1)-230.903(c)(3) (1994).

177. *Id.* § 230.903(c)(1). Because this Note deals exclusively with problems related to securities sold by U.S. issuers, Category One will not be discussed.

178. See *supra* note 161 and accompanying text (discussing definition of "reporting issuer").

179. 17 C.F.R. § 230.903(c)(2).

180. *Id.* § 230.903(c)(3).

181. Berger, *supra* note 4, at 585. Use of the safe harbor as part of a scheme to evade the Securities Act registration requirements constitutes misuse. 17 C.F.R. §§ 230.901-230.904 *prelim. n.2*. The provisions of the various safe harbors reflect the likelihood of flowback into the United States, and the amount of information available to the U.S. markets regarding the issuer. Adopting Release, 55 Fed. Reg. 18,306, 18,313 (May 2, 1990). Investors in corporate debt, unlike purchasers of stock, are protected not only by U.S. securities laws, but also by the negotiated indenture, or debt agreement. See LEWIS D. SOLOMON ET AL., CORPORATIONS: LAW AND POLICY 227 (1994) (discussing contents of debt indentures).

182. See *supra* note 161 and accompanying text (defining reporting issuer).

183. Adopting Release, 55 Fed. Reg. 18,306, 18,316. If flowback does occur, the information relating to the reporting issuers securities that is publicly available under the Exchange Act will ensure investor protection. *Id.* The Securities Exchange Act of 1934 requires reporting companies to file quarterly and annual financial and informational reports, called 10-Qs and 10-Ks, on the financial status of the company. See Securities Exchange Act of 1934, 15 U.S.C. § 78m (1988 & Supp. V 1993); see also ROBERT E. SHIELDS & ROBERT H. STROUSE, SECURITIES PRACTICE HANDBOOK 310-19 (5th ed. 1987) (discussing reporting requirements of Exchange Act).

tions for securities offered by reporting issuers than for non-reporting issuers, and, in Category Three, for debt rather than equity securities.¹⁸⁴

The SEC's primary concern in Category Two is the prevention of distributions of unregistered securities by reporting issuers¹⁸⁵ within the United States after U.S. investors have been primed for acceptance.¹⁸⁶ Securities in Category Two must comply with two offering restrictions¹⁸⁷ and two transactional restrictions.¹⁸⁸ The offering restrictions are shielding measures designed to ensure compliance with Regulation S.¹⁸⁹ The first offering restriction requires each distributor to agree in writing that all offers and sales made prior to the expiration of the forty-day period shall be made in compliance with all applicable provi-

184. See Proposed Rules, 53 Fed. Reg. 22,661, 22,672 (June 17, 1988) (discussing procedures of issuer safe harbors). Few transactional restrictions are imposed on securities offered by reporting issuers. *Id.* Significant transactional restrictions are imposed, however, on non-reporting issuers. *Id.* Furthermore, the risk of flowback into the United States of various categories of securities determines the amount of restrictions imposed on the offering. *Id.* Therefore, having recognized that the market for debt consists primarily of institutional investors and that the likelihood of flowback is limited, the SEC has imposed more restrictive procedures on category three equity than debt. *Id.*

185. See *supra* note 161 and accompanying text (defining reporting issuer).

186. CORPORATE PRACTICE LEAFLET, *supra* note 156, at A-8.

187. Regulation S, 17 C.F.R. § 230.902(h) (1994). Rule 902(h) defines "offering restrictions" in pertinent part as follows:

(1) Each distributor [must agree] in writing that all offers and sales of the securities prior to the expiration of the restricted period specified in section 230.903(c)(2) or (3), as applicable, shall be made only: in accordance with the provisions of section 230.903 or section 230.904; pursuant to registration of the securities under the Act; or pursuant to an available exemption from the registration requirements of the [Securities] Act; and

(2) All offering materials and documents (other than press releases) used in connection with offers and sales of the securities prior to the expiration of the restricted period specified in section 230.903(c)(2) or (3), as applicable, shall include statements to the effect that the securities have not been registered under the Act and may not be offered or sold in the United States or to U.S. persons (other than distributors) unless the securities are registered under the [Securities] Act, or an exemption from the registration requirements of the Act is available

Id.

188. See Wolff, *supra* note 4, at 135-39 (discussing transactional restrictions of Regulation S safe harbors). Transactional restriction is a term that is peculiar to the adopting release. *Id.* at 136. It includes procedures that are specific to the individual safe harbor categories, such as restricted periods, during which no sales may be made to U.S. persons, and identifying legends that must be placed on the securities. *Id.*

189. Wolff, *supra* note 4, at 136.

sions of Regulation S.¹⁹⁰ The second offering restriction requires that advertisements, tombstones,¹⁹¹ prospectuses,¹⁹² and all other materials, except press releases, used to facilitate the initial sale of Category Two securities state that the securities are unregistered and cannot be offered or sold in the United States absent registration or a valid exemption.¹⁹³ Furthermore, the marketing materials must also specify that the securities cannot be offered or sold to U.S. persons, except distributors, during the applicable restricted period unless they are registered or qualify for an exemption from the registration requirements.¹⁹⁴ The Category Two safe harbor transactional restrictions are as follows.¹⁹⁵ First, during a forty-day restricted period, the offer or sale may not be made to, or for the account or benefit of, a U.S. person other than a distributor.¹⁹⁶ Second, any distributor, dealer, or person receiving a selling commission for Category Two securities sold during the forty-day restricted period must send a confirmation or notice to the purchaser informing them that they are subject to the same restrictions that apply to the

190. 17 C.F.R. § 230.902(h)(1); *see supra* note 187 and accompanying text (discussing offering restrictions on Regulation S distributions).

191. *See* MARSHALL & ELLIS, *supra* note 5, at 70. A "tombstone" is an advertisement, usually in major financial newspapers or periodicals, that a public offering of securities is being made. *Id.* It does not constitute an offer to sell or a solicitation of an offer to buy securities, and must state so clearly. *Id.*

192. Securities Act of 1933 § 2(10). The Securities Act defines prospectus as "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." *Id.* The Securities Act mandates that corporations making public stock offerings file a prospectus with the SEC as part of the registration statement. *Id.* § 6. The issuer must follow the format for its prospectus prescribed in Schedule A of the Securities Act. *Id.* § 7.

193. 17 C.F.R. § 230.902(h)(2); *see supra* note 187 and accompanying text (discussing offering restrictions imposed on Regulation S distributions).

194. Regulation S, 17 C.F.R. § 230.902(h)(2) (1994).

195. *See* Adopting Release, 55 Fed. Reg. 18,306, 18,316 (May 2, 1990) (discussing contents of transactional restrictions).

196. 17 C.F.R. § 230.903(c)(2)(iii). Rule 902(m) defines "restricted period" as the "period that commences on the later of the date upon which the securities were first offered to persons other than distributors in reliance upon this Regulation S or the date of closing of the offering, and expires" on a date specified in Rule 903(c)(2) or (3). 17 C.F.R. § 230.902(m) (1990). Regardless of the number of days specified in the specific safe harbor, sales made by distributors from an allotment are considered to be made during the restricted period. CORPORATE PRACTICE LEAFLET, *supra* note 156, at A-8 n.30. Rule 902(c) defines distributor as "any underwriter, dealer, or other person who participates, pursuant to a contractual arrangement, in the distribution of the securities offered or sold in reliance on this Regulation S." 17 C.F.R. § 230.902(c).

distributor.¹⁹⁷

Unlike the SEC's approach in Category Two, which presupposes that significant issuer information is available to market participants,¹⁹⁸ the SEC developed Category Three with the assumption that little, if any, information is available to the market concerning the issuer and its securities.¹⁹⁹ As a result, Regulation S places the strongest restrictions of all on sales of Category Three securities.²⁰⁰ Under Category Three, securities are subject not only to the general conditions²⁰¹ and offering conditions,²⁰² but issuers must also meet a set of increased transactional restrictions.²⁰³ These transactional restrictions are similar to procedures adopted under Release 4708.²⁰⁴ During a forty-day restricted period, debt securities must be represented by a non-transferable temporary global security and may not be exchanged for a permanent bond until the restricted period has expired and the purchaser has certified that he is either a non-U.S. person or a U.S. person who purchased the debt in an exempted transaction.²⁰⁵ All Category Three equity securities sold under Regulation S, other than non-convertible, non-participating preferred stock,²⁰⁶ and asset-backed securities,²⁰⁷ are subject

197. 17 C.F.R. § 230.903(c)(2)(iv).

198. See Adopting Release, 55 Fed. Reg. 18,306, 18,316. (discussing SEC concerns about flowback of Regulation S securities). The SEC has stated that in the event of flowback of Category Two securities, the information available due to the Exchange Act reporting requirements should ensure investor protection. *Id.*

199. Adopting Release, 55 Fed. Reg. 18,306, 18,318 (May 2, 1990).

200. *Id.*

201. 17 C.F.R. § 230.901; see *supra* notes 166-74 and accompanying text (discussing the general restrictions on issuance and resales under Regulation S).

202. 17 C.F.R. § 230.902(h); see *supra* note 187 and accompanying text (discussing offering restrictions imposed on securities issued pursuant to Regulation S).

203. See Adopting Release, 55 Fed. Reg. 18,306, 18,318 (discussing increased transactional restriction for Category Three securities).

204. Adopting Release, 55 Fed. Reg. 18,306, 18,318.

205. 17 C.F.R. § 230.903(c)(3)(ii)(B). Once the 40-day restricted period ends, but prior to exchanging the Temporary Global Security for a definitive security, the Temporary Global Security holder must certify beneficial ownership by a non-U.S. person or a U.S. person who bought the securities in an exempt transaction. Adopting Release, 55 Fed. Reg. 18,306, 18,319.

206. 17 C.F.R. § 230.903(c)(4)(i). Regulation S defines non-participating preferred stock as "[n]on-convertible capital stock, the holders of which are entitled to a preference in payment of dividends and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in residual earnings or assets of the issuer." *Id.*

207. *Id.* § 230.903(c)(4)(ii). Regulation S defines asset backed securities as follows:

to a one-year, rather than forty-day, restricted period.²⁰⁸ During this one-year period, the equity securities of all U.S. issuers must be stamped with a legend mandating that all transfers be made according to the requirements of Regulation S.²⁰⁹ Furthermore, the issuer must place a provision in its charter or by-laws, or agree by contract, that it may not register any transfer of securities made in contravention of Regulation S.²¹⁰ Additionally, all non-distributor purchasers of Category Three equity securities must certify in writing that they are not U.S. persons and are not purchasing the securities for a U.S. person unless the transaction is exempted from registration under other SEC rules.²¹¹ Lastly, the buyer must agree to abide by the resale provisions²¹² of Regulation S unless the securities are registered by the issuer or another exemption is available.²¹³

ii. Resale Safe Harbor

Because Section 5 of the Securities Act requires registration of all securities sold,²¹⁴ all sales of unregistered securities require an exemption from registration, regardless of whether the sale is

(ii) Securities of a type that either:

(A) Represents an ownership interest in a pool of discrete assets, or certificates of interest or participation in such assets (including any rights designed to assure servicing, or the receipt or timeliness of receipt by holders of such assets, or certificates of interest or participation in such assets, of amounts payable thereunder), provided that the assets are not generated or originated between the issuer of the security and its affiliates; or

(B) Is secured by one or more assets or certificates of interest or participation in such assets, and the securities, by their terms, provide for payments of principal and interest (if any) in relation to payments or reasonable projections of payments on assets meeting the requirements of paragraph (c)(4)(ii)(A) of this section, or certificates of interest or participations in assets meeting such requirements.

Id. For the purposes of the preceding section, Regulation S defines assets as "securities, installment sales, accounts receivable, notes, leases or other contracts, or other assets that by their terms convert into cash over a finite period of time." *Id.*

208. *Id.* § 230.903(c)(3)(iii)(A). Non-convertible, non-participating preferred stock and asset backed securities are included in the Category Two safe harbor. *Id.* § 230.903(c)(2).

209. *Id.* § 230.903(c)(3)(iii)(B)(3).

210. *Id.* § 230.903(c)(3)(iii)(B)(4).

211. *Id.* § 230.903(c)(3)(iii)(B)(1).

212. *See id.* § 230.904 (discussing provisions of resale safe harbor).

213. *Id.* § 230.903(c)(3)(iii)(B)(2).

214. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1988 & Supp. V 1993); *see supra* note 81 (describing contents of Section 5 of Securities Act).

made by the issuer or a subsequent purchaser.²¹⁵ In the absence of such an exemption, the reseller is subject to sanctions and may also place the issuer's exemption at risk.²¹⁶ Section 4(2) of the Securities Act provides such an exemption for private offers and sales of securities by issuers.²¹⁷ Regulation D prescribes non-exclusive rules that issuers may follow to qualify for this private placement exemption.²¹⁸ Section 4(1)²¹⁹ of the Securities Act grants an exemption for sales of securities by anyone who is not an issuer, underwriter, or dealer.²²⁰ Although this exemption appears to be expansive, it has been construed narrowly by both the SEC and the federal courts.²²¹ For example, SEC Rule

215. Securities Act of 1933 § 5.

216. *See supra* notes 100-05 and accompanying text (discussing SEC sanctions and private remedies available for violation of Securities Act registration requirements).

217. Securities Act of 1933 § 4(2). The registration requirements of the Securities Act do not apply to "transactions by an issuer not involving any public offering." *Id.* This is the "private placement exemption." JOHNSON, *supra* note 1, at 315. Private placements are used for transactions ranging from the issuance of stock in a new, closely held corporation to placements of large amounts of securities with institutional investors by Fortune 500 companies. *Id.*

218. Regulation D — Rules Governing the Limited Offer and Sale of Securities without Registration under the Securities Act of 1933, 17 C.F.R. §§ 230.501-230.506 (1994).

219. Securities Act of 1933 § 4(1). The registration requirements of the Securities Act do not apply to "transactions by any person other than an issuer, underwriter or dealer." *Id.*

220. Securities Act of 1933 § 2(11). The Securities Act defines "underwriter" as follows:

The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission.

Id.

221. *See* Securities & Exchange Commission v. Chinese Consolidated Benevolent Assoc., 120 F.2d 738 (2d Cir. 1941) (holding that benevolent committee set up to sell Chinese government bonds to provide relief for nationalist government fighting Japanese occupation was an underwriter within the meaning of the Securities Act); *see also* Securities and Exchange Commission v. Guild Films Co., 279 F.2d 485 (2d Cir. 1960) (holding that sale of unregistered securities held as collateral by bank violated Section 5 of Securities Act). The underwriter defined in section 2(11) has been termed the "statutory underwriter." *See* JENNINGS, *supra* note 1, at 459-60 (discussing concept of statutory underwriter). The SEC has also developed an unofficial "presumptive underwriter" doctrine. *Id.* This doctrine has been defined in the following terms:

A person may be deemed to be an underwriter, within the meaning of § 2(11)

144,²²² which provides a non-exclusive safe-harbor under the Section 4(1) exemption, stringently restricts resales of unregistered U.S. corporate securities bought in private placements.²²³ Rule 904, the resale safe harbor of Regulation S, however, loosens the restrictions.²²⁴ It provides broad, non-exclusive protection from sanctions for all offshore resales of unregistered securities made by persons who are not members or affiliates of the issuing group,²²⁵ as long as they meet the same general restrictions prescribed for issuers.²²⁶ For the purposes of the resale safe harbor, sales may be made on any "designated offshore securities market."²²⁷

of the Securities Act, if such person purchases or acquires a significant percentage of the securities offered pursuant to a registered distribution, except that such person is not deemed to be an underwriter if he resells such securities in limited quantities.

Robert J. Ahrenholz & William E. Van Valkenberg, *The Presumptive Underwriter Doctrine: Statutory Underwriter Status for Investors Purchasing a Specified Portion of a Registered Offering*, 1973 UTAH L. REV. 773, 775-76 (1973). The SEC establishes quantity limitations on resales of privately placed securities in Securities Act Rule 144. See Rule 144 — Persons Deemed Not to Be Engaged in a Distribution and Therefore Not Underwriters, 17 C.F.R. § 230.144(e).

222. 17 C.F.R. § 230.144.

223. *Id.* Rule 144 is designed to promote "full and fair" disclosure of information concerning new issues, to prohibit the creation of markets in securities for which little or no information is available, and to allow limited sales of restricted securities according to strict rules. *Id.* To ensure adequate disclosure, Rule 144 requires the filing of financial reports. *Id.* § 230.144(c). To assure that purchasers have accepted the economic risks inherent in the unregistered security, and are not acting as conduits for the issuer, Rule 144 also mandates a two year restricted holding period from the date of purchase of the securities from the issuer or an affiliate of the issuer. *Id.* § 230.144(d)(1). Finally, to ensure that resales are "routine trading transactions," and not distributions disguised as routine trades, Rule 144 also places tight limits on the number of securities that can be sold in any given three month period. *Id.* § 230.144(e).

224. Regulation S, 17 C.F.R. § 230.904 (1994).

225. Wolff, *supra* note 4, at 141. The "issuing group" includes the issuer, distributors, affiliates thereof, and their agents. *Id.*

226. 17 C.F.R. §§ 230.904(a), 230.904(b); see *supra* notes 166-74 and accompanying text (discussing general restrictions of Regulation S).

227. 17 C.F.R. § 230.902(a). Regulation S defines "designated offshore securities market" in pertinent part as follows:

(a) Designated Offshore Securities Market. "Designated offshore securities market" means:

(1) The Eurobond market, as regulated by the Association of International Bond Dealers; the Amsterdam Stock Exchange Ltd., the Bourse de Bruxelles; the Frankfurt Stock Exchange; The Stock Exchange of Hong Kong Limited, The International Stock Exchange of the United Kingdom and the Republic of Ireland, Ltd.; the Johannesburg Stock Exchange; the

Under Rule 904, certain officers and directors of issuers and distributors are not considered to be members of the issuing group. They may, therefore, resell securities of the issuer provided they pay no selling concession or fee to their distributors, other than a standard brokers' commission, in connection with the offer or sale.²²⁸ In order to ensure that these resales are not part of a scheme to avoid the Securities Act registration requirements, however, officers and directors of issuers may not resell securities during the Regulation S distribution or restricted period.²²⁹

The resale safe harbor is also available to dealers²³⁰ and other persons who have received selling concessions prior to the expiration of any restricted period as long as they meet two conditions.²³¹ First, neither the seller nor his agent may know that the offeree or purchaser of the securities is a U.S. person.²³² The seller, however, has no affirmative duty to inquire whether the purchaser is a U.S. person.²³³ Second, if the purchaser is a dealer or person receiving a selling concession, the seller must send to such purchaser a confirmation stating that during the remainder of the restricted period any offers or sales of the security must be made in accordance with Regulation S, unless another exemption exists.²³⁴

Bourse de Luxembourg; the Borsa Valori di Milan; the Montreal Stock Exchange; the Bourse de Paris; the Stockholm Stock Exchange; the Tokyo Stock Exchange; the Toronto Stock Exchange; the Vancouver Stock Exchange; and the Zurich Stock Exchange; and

(2) Any foreign securities exchange or non-exchange market designated by the Commission.

Id.

228. 17 C.F.R. § 230.904(c)(2).

229. Adopting Release, 55 Fed. Reg. 18,306, 18,319 n.139 (May 2, 1990).

230. Securities Act of 1933 § 2(12), 15 U.S.C. § 77b (1988 & Supp. V 1993). The Securities Act defines "dealer" as "any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person."

Id.

231. Regulation S, 17 C.F.R. § 230.904(c)(1) (1994).

232. 17 C.F.R. § 230.904(c)(1)(i).

233. See Adopting Release, 55 Fed. Reg. 18,306, 18,319 (discussing provisions of resale safe harbor). The SEC has stated that "[t]he safe harbor does not place a duty of inquiry on the securities professional." *Id.* at 18,319 n.140.

234. 17 C.F.R. § 230.904(c)(1)(ii). As was the case with the issuer safe harbor, the confirmation need only be transmitted, not received or delivered. Adopting Release, 55 Fed. Reg. 18,306, 18,319 n.141.

c. The Effects of Non-Compliance with the Safe Harbor Provisions

In keeping with the SEC's intention to open up the offshore markets while maintaining protections against flowback,²³⁵ the Commission has limited the scope of Regulation S.²³⁶ The most important restriction, the anti-evasion rule found in Preliminary Note 2, states that Regulation S may not be used as part of a scheme to evade the registration requirements of the Securities Act.²³⁷ This general rule, which is applicable to all transactions under Regulation S, makes it clear that fraudulent transactions made under the aegis of the regulation will be treated as a violation of the Securities Act registration requirements.²³⁸

The SEC detailed its positions regarding non-compliance with the specific safe harbor provisions in the Adopting Release ("Release").²³⁹ The Release states that the primary offering safe harbor is lost to all persons in connection with the offering if any member of the issuing group,²⁴⁰ other than officers or directors

235. See Adopting Release, 55 Fed. Reg. 18,306, 18,312 (discussing criteria used for imposing safe harbor restrictions on various types of securities).

236. See *id.* at 18,319 (discussing limitations on application of safe harbors).

237. See Regulation S, 17 C.F.R. §§ 230.901-230.904 prelim. n.2. Preliminary Note 2 states as follows:

In view of the objective of these rules and the policies underlying the Act, Regulation S is not available with respect to any transaction or series of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the act. In such cases, registration under the Act is required.

Id.

238. Adopting Release, 55 Fed. Reg. 18,306, 18,319-20 (May 2, 1994). The SEC provides two examples of actions by underwriters that would violate the anti-evasion rule. *Id.* at 18,320. First, an underwriter who is in technical compliance with Regulation S cannot rely on the regulation if he or she knows or is reckless in not knowing that a dealer to whom he or she intends to sell the securities has a customer waiting to purchase them in the United States. *Id.* Second, the underwriter cannot rely on Regulation S if he or she knew or was reckless in not knowing that the dealer to whom he or she intended to sell regularly resold Regulation S securities to customers in the United States. *Id.*; see *supra* notes 87-99 and accompanying text (discussing Securities Act registration requirements).

239. See Adopting Release, 55 Fed. Reg. 18,306, 18,319-20 (discussing results of violations of safe harbors by offshore market participants). Despite the fact that these holdings are contained in the release, rather than the rules, the courts are likely to give them deference. Wolff, *supra* note 4, at 141. Courts have given deference to SEC Releases in the past. See *Hocking v. Dubois*, 839 F.2d 560, 565-66 (9th Cir. 1988) (citing SEC Release 5347 as controlling); see also *Johnson v. Nationwide Indus., Inc.*, 450 F. Supp. 948, 953 (N.D. Ill. 1978) (using SEC Release guidelines to decide case).

240. See Wolff, *supra* note 4, at 141.

legitimately relying on the resale safe harbor, violates the offering restrictions or engages in directed selling efforts in the United States.²⁴¹ According to the SEC, this approach promotes full compliance with all of the safe harbor conditions.²⁴²

The SEC is somewhat less strict about violations of the transactional restrictions.²⁴³ If any member of the issuing group violates any of the transactional procedures of the issuer safe harbor, only that entity, its affiliates, and agents lose safe harbor protection.²⁴⁴ The other members of the issuing group remain unaffected.²⁴⁵ The Release also states that offshore purchasers of Regulation S securities, or others who rely on the resale safe harbor, are unaffected by violations of the issuer safe harbor by members of the issuing group.²⁴⁶

Finally, Regulation S does not remove the requirement that offshore issuers, their agents, and distributors must comply with the antifraud provisions of the U.S. securities laws.²⁴⁷ Private investors, therefore, still retain the right to sue issuers, distributors, and sellers of Regulation S securities under the antifraud statutes of the Securities Act²⁴⁸ and the Securities Exchange Act of 1934.²⁴⁹ In addition, Regulation S does not prohibit the SEC

241. Adopting Release, 55 Fed. Reg. 18,306, 18,319.

242. *Id.*

243. *See id.* at 18,319-20 (discussing effects of violations of transactional restrictions).

244. *Id.*

245. *Id.*

246. *Id.*

247. Regulation S, 17 C.F.R. §§ 230.901-230.904 prelim. n.1 (1994). Preliminary Note 1 states that "the following rules relate solely to the application of Section 5 of the Securities Act of 1933 . . . and not to antifraud or other provisions of the federal securities laws." *Id.* The SEC has stated that "different considerations apply to the extraterritorial application of the antifraud provisions than to the registration provisions of the Securities Act." Adopting Release, 55 Fed. Reg. 18,306, 18,309 (May 2, 1990).

248. *See* Securities Act of 1933 § 11 (discussing civil liabilities on account of filing of false registration statements); *id.* § 17 (discussing fraudulent interstate transactions); *id.* § 12 (discussing private remedy for fraudulent statements or omissions of material information in registration statement).

249. *See* Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (discussing prohibition on fraudulent practices in connection with purchases or sales of securities). Section 10(b) states as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or the mails, or of any facility of any national securities exchange . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered,

from imposing administrative sanctions on, seeking injunctions and fines against, or recommending that the U.S. District Attorney prosecute individuals and organizations who make false or misleading claims in offshore transactions.²⁵⁰

II. REGULATION S IN OPERATION

The SEC expected that the adoption of Regulation S would improve U.S. corporate access to, and competitiveness within, the offshore securities markets.²⁵¹ By streamlining the procedures necessary to ensure compliance with the SEC's offshore rules, Regulation S has provided greater certainty for issuers and resellers in the planning of offshore transactions.²⁵² Despite this positive result, Regulation S has also reduced the ability of the SEC to monitor offshore transactions prior to issuance because, unlike under Release 4708, issuers are no longer compelled to seek individual approval from the SEC for their offshore transactional procedures.²⁵³ One result has been an increase in offshore abuses since Regulation S was adopted.²⁵⁴ This, in turn, has increased the number of unregistered securities flowing back into the hands of U.S. investors.²⁵⁵

any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.; see also Securities Exchange Act of 1934 Rule 10b-5, 17 C.F.R. § 240.10b-5 (1994) (discussing SEC prohibition on employment of manipulative and deceptive practices in purchases or sales of securities).

250. See Adopting Release, 55 Fed. Reg. 18,306, 18,308-09 (discussing application of antifraud provisions of Securities Act to offshore securities transactions). For a comprehensive discussion of Securities Fraud, see Andreas L. Ciota et al., *Securities Fraud*, 31 AM. CRIM. L. REV. 827 (1994).

251. R. Brandon Asbill, *Securities Regulation—Great Expectations and the Reality of Rule 144A and Regulation S; The SEC's Approach to the Internationalization of the Financial Marketplace*, 21 GA. J. INT'L & COMP. L. 145, 162 (1991). Richard Breeden, the chairman of the SEC at the time Regulation S was adopted, declared that the regulation would increase U.S. competitiveness in offshore markets, and lower the cost of capital for U.S. Issuers. *Id.*

252. Coogan & Kimbrough, *supra* note 10, at 3.

253. See *supra* note 127-33 and accompanying text (discussing corporate use of no-action process to ensure compliance with Release 4708).

254. See Cohen, *supra* note 18, at C1 (discussing abusive use of Regulation S).

255. See *supra* note 18 and accompanying text (discussing SEC's belief that there has been substantial flowback of unregistered securities under Regulation S).

A. *How the Issuer Benefits by Selling Securities on the Offshore Capital Markets*

Prior to the adoption of Regulation S, some members of the U.S. investment industry maintained that, due to U.S. restrictions on offshore securities offerings, U.S. issuers were at a disadvantage to their overseas counterparts in the offshore markets.²⁵⁶ The compliance responsibilities imposed by Release 4708²⁵⁷ and its no-action letters²⁵⁸ often meant that both the cost benefits and time savings available to non-U.S. offshore issuers were not available to U.S. companies.²⁵⁹ In addition, SEC restrictions on resales of unregistered U.S. corporate securities by offshore investors limited the size of the offshore market for U.S. corporate issues by restricting the liquidity of both U.S. debt and equity securities.²⁶⁰ Regulation S significantly reduced the issuer's compliance responsibilities and provided a broad resale exemption,²⁶¹ thereby allowing U.S. corporations to capture more of the benefits inherent in the use of offshore funding.²⁶²

Use of the Regulation S procedures to raise capital in the virtually unregulated offshore markets provides a variety of advantages that are not available with solely domestic offers and sales.²⁶³ First, by using Regulation S to raise funds overseas, U.S. corporations can reduce their cost of capital.²⁶⁴ Offshore issu-

256. See Wolff, *supra* note 4, at 112-13 (discussing clamor by U.S. issuers and investors for relaxation of offshore application of Securities Act registration requirements). During the 1980's a number of transnational market participants decried the restrictive nature of the SEC approach to the extraterritorial application of the Securities Act registration requirements. *Id.* They argued that Release 4708 increased the cost of capital for U.S. issuers. *Id.*

257. Release 4708, *supra* note 117, at 1-2.

258. See *supra* notes 120-33 and accompanying text (discussing compliance procedures approved by SEC in no-action letters under Release 4708).

259. See *supra* notes 134-39 and accompanying text (discussing costs of offshore issuance under Release 4708).

260. See *supra* notes 114-26 and accompanying text (discussing SEC's expansive approach to extraterritorial application of Securities Act prior to Regulation S).

261. See *supra* notes 137-44 and accompanying text (discussing simplification of offshore issuance procedures under Regulation S).

262. See Kelley & Bannister, *supra* note 11, at 166 (discussing benefits of using Regulation S); see *supra* notes 145-234 (discussing guidelines of Regulation S); see also MARSHALL & ELLIS, *supra* note 5, at 78-79 (discussing benefits to corporations of using offshore markets).

263. See Hagger, *supra* note 55, at 22 (discussing benefits to issuer of offshore issuance).

264. *Id.* The most important rule of investing is that the investor should always seek the best rate of return with the lowest risk. See BODIE, *supra* note 48, at 142 (dis-

ance, especially in conjunction with a distribution in the United States, can increase the demand for an offering, resulting in higher prices for both debt and equity and a windfall to the issuer.²⁶⁵ This reduced cost of capital, however, is partially offset by discounts that issuers must give offshore investors to compensate them for the liquidity limitations imposed by the transactional restrictions²⁶⁶ of Regulation S.²⁶⁷ Second, by providing definitive guidelines to qualify for safe harbor treatment, Regulation S allows companies to avoid the high costs of requesting no-action letters or registering.²⁶⁸ Third, Regulation S offerings enable companies to raise money more quickly than if registration is required.²⁶⁹ They also permit companies that do not want to detail their financial condition and business plans to the domestic market to raise funds discreetly.²⁷⁰ Finally, use of the offshore markets enables a company to create an international base for its stock,²⁷¹ open up new sources of capital,²⁷² increase the size of

cussing concepts of risk and risk aversion). Although not always the case, investing internationally tends to entail higher risk than investing domestically. *Id.* at 854. International risks include exchange-rate fluctuations, restrictions on cross-border capital flows, political risks, and differences in accounting practices from one country to another. *Id.* As a result, offshore investors generally seek higher returns for their international investments than they can receive at home. *See, e.g.,* Testy, *supra* note 115, at 930-31. U.S. corporate issuers can, however, reduce their cost of capital while still offering good investment opportunities to offshore investors for two reasons. First, U.S. corporations can pay lower interest rates on debt to offshore investors than to U.S. persons because the U.S. Internal Revenue Code exempts non-U.S. persons from withholding taxes on interest paid on U.S. corporate debt securities. *See* Internal Revenue Code, 26 U.S.C. § 871(h) (1994). Second, Euromarket underwriting fees tend to be much lower than U.S. domestic underwriting fees. Simon Brady & Matthew Ball, *Don't Miss Out On The Euro Boom*, CORP. FIN., Oct. 1993, at 24. Taken together, these factors not only enable major U.S. corporations to utilize the offshore markets to reduce their cost of capital, but they also allow smaller U.S. companies to gain access to financing that might not be available in the United States. Cohen, *supra* note 18, at C1.

265. Hagger, *supra* note 55, at 22.

266. *See* Cohen, *supra* note 18, at C1 (discussing illiquidity premiums given to primary market purchasers of Regulation S securities).

267. Charles Fleming, *Europe's Fund Managers Say Offers of 'Regulation-S' Shares Are Proliferating*, WALL ST. J. EUR., Mar. 29, 1994, at 13. Discounts to "market price" have ranged between 9% for registered United States corporations, such as the former Primerica Corporation (now The Travelers, Inc.), Cohen, *supra* note 18, at C1, and 40% for small unknown companies. Fleming, *supra* note 267, at 13.

268. *See* Fleming, *supra* note 267, at 13 (discussing why U.S. issuers use Regulation S).

269. *Id.*

270. *Id.*

271. *See* Hagger, *supra* note 55, at 22 (discussing benefits to issuers of offshore offerings).

the issue,²⁷³ limit the effects of local sentiment on share prices,²⁷⁴ and develop the liquidity necessary to make the offering a success on the secondary markets.²⁷⁵

B. *The Effect of Regulation S on U.S. Corporate Involvement in the Offshore Financial Markets*

Because the offshore financial markets are largely unregulated,²⁷⁶ it is nearly impossible to determine its exact size, or the effect that Regulation S has had in increasing U.S. corporate involvement in international securities issuance.²⁷⁷ The only evidence, albeit circumstantial, that Regulation S has positively influenced U.S. offshore issuance is that the size of the international bond and equity markets has greatly increased over the last twenty years,²⁷⁸ and that this increase, especially as regards the Euroequity markets, has accelerated since the adoption of Regulation S.²⁷⁹ In fact, in 1993, ten of the top fifteen international equity issuers were U.S. companies.²⁸⁰

According to a number of investment bankers and lawyers who participate in offshore offerings, Regulation S transactions have increased in popularity over the last four years.²⁸¹ As of

272. *Id.*

273. *Id.*

274. *Id.*

275. *Id.*

276. See Cohen, *supra* note 18, at C1 (discussing lack of regulation of offshore markets).

277. *Id.* It is impossible to tell exactly how many Regulation S transactions have taken place, because no one tracks the offshore markets. *Id.*

278. See *supra* notes 28-55 and accompanying text (discussing growth of international securities markets).

279. See Simon Brady, *All Records Smashed in 1993*, CORP. FIN., Jan. 1994, at 6 (discussing expansion of international securities market from 1992 to 1993). Offshore bond issuance grew from US\$276 billion in 1992 to US\$399 billion in 1993. *Id.* Offshore equity issuance grew at an even more rapid pace. *Id.* at 10. In 1992 approximately US\$25 billion in equity was issued outside of issuers home markets. *Id.* In 1993 more than US\$75 billion worth of primary stock issues sold outside issuers' home countries, an all-time record. *Id.*

280. See *id.* (table showing largest corporate issuers of international equity during 1993).

281. Cohen, *supra* note 18, at C1. Some investment bankers involved in the offshore markets estimate that the Regulation S market may account for as much as five percent of all U.S. issues since 1990. Fleming, *supra* note 267, at 13. One example of the type of corporation that uses Regulation S is Work Recovery, Inc., a small, troubled U.S. company that was able to sell US\$500,000 worth of its stock to a major British pension fund soon after the regulation was adopted. John R. Emshwiller, *Need for Money*

March 1994, European investment fund managers were being offered a growing number of opportunities to purchase Regulation S securities.²⁸² The increasing use of Regulation S by U.S. issuers can be attributed to the accepted maxim that a company must issue outside of its domestic market in order to lower its cost of capital and broaden its investor base.²⁸³

C. Flowback, Evasion, and Discounting Problems Since the Adoption of Regulation S

Although the adoption of Regulation S has increased the number of offshore transactions involving U.S. issuers and investors,²⁸⁴ greater U.S. corporate access to the international markets has also brought two major problems. First, counter to the SEC's expectations,²⁸⁵ flowback of unregistered securities into the United States appears to have grown considerably over the last five years.²⁸⁶ This increased flowback undermines the disclosure provisions of the U.S. securities laws.²⁸⁷ Second, deep discounting of Regulation S stock has enabled offshore investors to use Regulation S shares to cover short sales of stock traded on the U.S. markets.²⁸⁸ The SEC did not intend to give this kind of

Pulls Young Firms Into Risky Deals, WALL ST. J., Mar. 31, 1992, at B1. Unfortunately, the next time the same company attempted a Regulation S offering, 400,000 shares of stock were stolen by the investment bankers it had hired. *Id.*

282. See Fleming, *supra* note 267, at 13 (discussing proliferation of Regulation S offers in Europe).

283. Hagger, *supra* note 55, at 22.

284. See *supra* notes 276-83 and accompanying text (discussing effect that Regulation S has had on U.S. issuer use of offshore markets).

285. See Proposed Rules, 53 Fed. Reg. 22,661, 22,665 (June 17, 1988) (discussing SEC position that rules of Regulation S must ensure against indirect distribution in U.S. markets).

286. Commissioner Robert Y. Roberts, Commission Initiatives in International Corporate Finance, Address at the 14th Annual Northwest State Federal Provincial Securities Conference 3 (Feb. 26, 1993) (transcript available from SEC). Commissioner Roberts stated that "there are indications that reliance on the Regulation is possibly being claimed in sham transactions that are nominally offshore but in fact are transacted simply to evade registration." *Id.* at 3-4.

287. See Longstreth, *supra* note 139, at 30 (discussing whether Regulation S achieves purported goals of SEC). The SEC views flowback of unregistered U.S. corporate securities as a significant enough threat to the Securities Act disclosure scheme to warrant stringent restrictions on offshore issuance. *Id.*

288. See Cohen, *supra* note 18, at C1 (discussing use of Regulation S shares to cover short sales of U.S. listed stock); see also Thomas N. Cochran, *The Striking Price: Expiration Wednesday*, BARRON'S, Apr. 5, 1993, at 68 (discussing effect of Regulation S offering on share price of Primerica stock).

advantage to international investors.²⁸⁹

1. How Flowback Undermines the Investor Protections Contained in the Securities Act

Like any U.S. sale to the public of non-exempt,²⁹⁰ unregistered securities, flowback of non-exempt Category Two securities is inconsistent with the protective intent of the Securities Act, because it enables U.S. reporting companies to avoid disclosure.²⁹¹ As a result, although reporting companies must provide regular information to U.S. investors, the information available to the public at the time a Category Two security²⁹² flows back into the United States may not be current.²⁹³ In addition, by allowing unrestrained flowback of Category Two securities, the SEC may unintentionally encourage reporting companies to utilize Regulation S to avoid registration.²⁹⁴ Flowback of Category Three securities²⁹⁵ poses even more of a problem, because the average U.S. investor is unlikely to have any access to information concerning Category Three issuers.²⁹⁶ Therefore, unsophisticated U.S. investors may once again become victims of unscrupulous securities dealers, as was the case prior to 1933.²⁹⁷

289. See Cohen, *supra* note 18, at C1 (discussing SEC response to use of Regulation S shares by European investors to cover short sales of U.S. listed stock).

290. See *supra* note 82 and accompanying text (discussing two statutory exemptions from registration available to issuers and other sellers of securities).

291. Longstreth, *supra* note 139, at 30; see Proposed Rules, 53 Fed. Reg. 22,661, 22,662 (June 17, 1988) (discussing coming to rest abroad doctrine).

292. See *supra* note 179 and accompanying text (discussing securities covered by Category Two of Regulation S).

293. See Proposed Rules, 53 Fed. Reg. 22,661, 22,664 n. 53 (discussing disclosure requirements under Exchange Act). Reporting companies need only file quarterly, 17 C.F.R. § 249.308(a) (1994), and annual reports. 17 C.F.R. § 249.308 (1994).

294. See Roberts, *supra* note 286, at 4 (discussing SEC concerns about illicit use of Regulation S). There is evidence that some issuers may be using Regulation S solely to wash restrictions off the securities before bringing them back to the United States. *Id.* This method is quite tempting for issuers who want to sell in the United States while avoiding the costs of registration. *Id.*

295. See *supra* note 180 and accompanying text (discussing securities included in Category Three of issuer safe harbor).

296. Adopting Release, 55 Fed. Reg. 18,306, 18,318 (May 2, 1990).

297. See *supra* notes 73-80 and accompanying text (discussing fraud perpetrated on investors by securities issuers and dealers prior to adoption of Securities Act disclosure regime).

2. Evidence and Methods of Flowback in the Regulation S Era

Despite clear guidelines prohibiting the use of Regulation S to avoid registration,²⁹⁸ many issuers, particularly small companies encouraged by their investment bankers,²⁹⁹ have utilized the Regulation S facility to raise funds with full knowledge that their securities are likely to flow back to the United States immediately following the expiration of the applicable restricted period.³⁰⁰ Furthermore, the SEC believes that many of these same corporations are beginning to use Regulation S under the mistaken belief that the exemption wipes off all resale restrictions.³⁰¹ According to Commissioner Robert Y. Roberts of the SEC, sham transactions have occurred under both the primary offering and resale safe harbors.³⁰² Not only do these transactions constitute a violation of the prohibition on indirect distributions into the United States,³⁰³ but they also run counter to the principle that Regulation S was primarily intended to be used by large, financially-sound U.S. companies to place their securities with long-term offshore investors.³⁰⁴

There are two mechanisms through which flowback of Regulation S securities into the United States may occur. First, offshore purchasers can resell their securities to U.S. persons in the United States either prior to or after the expiration of the Regulation S mandatory restricted period, or any further restricted period contained in the agreement between the purchaser and the issuer.³⁰⁵ In the case of equity securities, this type of resale

298. See *supra* notes 237-38 and accompanying text (discussing prohibition against use of Regulation S as part of scheme to avoid registration under Securities Act).

299. See Cohen, *supra* note 18, at C1 (discussing U.S. corporate use of Regulation S). Onyx, a small investment bank in Miami, tells reporting companies that they can avoid registration by issuing offshore at a discount to market price. *Id.*

300. See *supra* notes 286-89 (discussing SEC concerns about flowback of Regulation S securities).

301. See Roberts, *supra* note 286, at 4 (discussing SEC fears of misuse of Regulation S by U.S. issuers).

302. Roberts, *supra* note 286, at 3-4.

303. *Id.*

304. See Cohen, *supra* note 18, at C1 (discussing reasons behind SEC development of Regulation S).

305. See, e.g., Securities and Exchange Commission v. Westdon Holding & Investment, Inc. et al., Litigation Release No. 13,263, 1992 WL 136673 (S.E.C.) (June 5, 1992) (discussing attempt by offshore investor to sell Regulation S shares to U.S. persons prior to expiration of restricted period). Regulation S shares may not be resold in the United States absent registration or a valid exemption, because resales under the offshore exemption provided by Regulation S must be made in an offshore transaction. 17 C.F.R.

cannot occur without the knowledge of the issuer because stock can only be transferred on the books of a corporation.³⁰⁶ If the securities do not qualify for an exemption that permits resale into the United States, such as the non-underwriter exemption of Section 4(1) of the Securities Act³⁰⁷ or the exemption for sales to sophisticated investors contained in Rule 144A,³⁰⁸ the resale is illegal, and may subject the offshore investor to SEC sanctions.³⁰⁹

The second method by which Regulation S securities can flow back into the United States is a two-step process. First, an offshore purchaser sells Regulation S securities to a U.S. person on a valid offshore market.³¹⁰ This is legal as long as the transfer of ownership occurs after the expiration of any restricted period.³¹¹ The second step occurs when the U.S. purchaser, in reliance on the non-underwriter exemption from registration contained in Section 4(1)³¹² of the Securities Act, legally resells the unregistered Regulation S securities in the U.S. over-the-counter market³¹³ or on a U.S. public securities exchange, such as the New York Stock Exchange.³¹⁴

§ 230.904(a); *see supra* notes 167-78 and accompanying text (discussing concepts of "offshore transaction" and "directed selling efforts").

306. *See* LEWIS D. SOLOMON ET AL., *CORPORATIONS: LAW AND POLICY* 439-40 (3d ed. 1994) (discussing composition of shareholder list). "A corporations records must list only the names of persons holding legal title to outstanding shares of stock." *Id.* at 439.

307. *See supra* note 82 (discussing exemption contained in Section 4(1) of Securities Act).

308. Rule 144A, 17 C.F.R. § 230.144A (1994). Once the restricted period has expired, Rule 144A allows the offshore purchaser to resell his stock to certain U.S. institutional investors without registration of the securities under the Securities Act. Fred A. Little, *Regulation S and Rule 144A*, C895 *ALI-ABA* 445, 447 (1994).

309. *See supra* notes 106-12 (discussing investigatory and sanctioning powers of SEC).

310. *See supra* note 142 and accompanying text (discussing ability of U.S. purchasers to buy Regulation S securities on offshore markets under certain circumstances).

311. *See supra* notes 213-34 and accompanying text (discussing Regulation S resale safe harbor).

312. Securities Act of 1933 § 4(1), 15 U.S.C. § 77d (1988 & Supp. V 1993); *see supra* notes 219-21 and accompanying text (discussing Section 4(1) of Securities Act).

313. *See* HAMILTON, *supra* note 47, at 538. The over-the-counter market consists of a group of broker-dealers, linked to each other through a computer network, who trade with each other, or for clients, without using the facilities of an organized securities exchange. *Id.*

314. Securities Act of 1933 § 4(1). The non-underwriter exemption states that "[t]he provisions of section 5 shall not apply to transactions by any person other than an issuer, underwriter, or dealer." *Id.* Under this exemption, U.S. persons who validly purchase Regulation S securities on an authorized offshore market can resell those securities in the United States as long as they can prove that they did not purchase from

3. An Attempt to Use Regulation S Evasively

In *SEC v. Westdon Holding & Investment, et al.*,³¹⁵ the SEC obtained a consensual permanent injunction against one of the defendants, Kishore J. Shah ("Shah"), a U.K. citizen, enjoining him from further violations of Regulation S.³¹⁶ According to the SEC, Shah had been involved in the purchase and illegal resale of Regulation S shares of Work Recovery, Inc., a U.S. company headquartered in Tuscon, Arizona.³¹⁷ As part of the purchase agreement, the defendant had agreed to hold the shares for five years, during which time the senior officers of the issuing corporation retained a repurchase option.³¹⁸ The complaint alleged that immediately after consummating the transaction the defendant embarked on a scheme to sell the shares to unsuspecting U.S. investors in violation of the Securities Act registration requirements, thereby reaping illegal proceeds totaling US\$380,000.³¹⁹ Despite agreeing to return the unsold shares, Shah was not forced to return the illegal proceeds,³²⁰ and his U.S. based assets, which had been frozen, were unfrozen upon his consent to the injunction.³²¹

Although there is evidence that evasive use of Regulation S has become common, *Westdon* is the only enforcement action for violations of Regulation S undertaken by the SEC since the adoption of the regulation.³²² The SEC, however, may now be ready to take action to correct the evasion problem. Members of the Commission and its staff have recently announced that use of Regulation S to wash off restrictions or otherwise evade the

the issuer with a view to distribute the securities, and did not offer to sell the shares in connection with a distribution. JENNINGS, *supra* note 1, at 512. Although this type of flowback is permitted by the Securities Laws, one must question whether, especially as regards Category Three securities, the holding periods currently mandated by Regulation S are long enough to protect unsophisticated U.S. investors by providing some assurance that the issuer will not become insolvent soon after the flowback occurs.

315. Securities and Exchange Commission v. Westdon Holding & Investment, Inc. et al., Litigation Release No. 13,263, 1992 WL 136673 (S.E.C.) (June 5, 1992).

316. *Id.*

317. *Id.*

318. *Id.*

319. *Id.*

320. *Id.* at 2.

321. *Id.*

322. Telephone Interview with Michael Hyatt, SEC Office of International Finance (Sept. 22, 1994).

registration requirements will not be tolerated.³²³ The Commission has also intimated that it will soon bring cases against a number of individuals and companies for Regulation S violations.³²⁴ Furthermore, the SEC recently stated that it is currently revisiting the regulation to determine if changes are warranted.³²⁵

4. The Discount Effect: How Unintentional Arbitrage Opportunities Promote Flowback

Corporate actions that contain material information affect the market price of a corporation's stock.³²⁶ Consequently, a decision by a reporting corporation to sell stock is often construed as a negative development by the market.³²⁷ This information, combined with the actual sale of the stock, may drive the price of the stock downwards.³²⁸ Because issuers need not announce a Regulation S distribution prior to the offer and sale,³²⁹ the market does not take this hidden information into account and, therefore, the stock price does not adjust accordingly.³³⁰ This market inefficiency enables offshore investors to engage in pure arbitrage³³¹ by using discounted Regulation S shares of reporting U.S. companies to cover short sales³³² of the same stock

323. See Roberts, *supra* note 286, at 4 (discussing SEC concerns about misuse of Regulation S). In February 1993, Commissioner Roberts warned potential violators they should not "be surprised when [they] receive a call from the SEC's enforcement division." *Id.* In early 1994, Bill McLucas, Director of the SEC Division of Enforcement, stated that his department will begin to investigate Regulation S transactions. *SEC Division of Corporate Finance Expresses Concerns*, INSIGHTS, Apr. 1994, at 36.

324. See Cohen, *supra* note 18, at C1 (discussing SEC investigations of Regulation S violations).

325. Telephone Interview with Michael Hyatt, SEC Office of International Finance (Sept. 22, 1994). As of this writing, the SEC has yet to officially follow through on its pronouncements.

326. RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 916 (4th ed. 1991).

327. *Id.* at 307-08.

328. *Id.* at 308.

329. See Cochran, *supra* note 288, at 68 (discussing SEC view that U.S. issuers need not announce Regulation S offerings in United States).

330. See BODIE, *supra* note 48, at G5 (discussing efficient market hypothesis). In an efficient market the price of securities reflects available information. *Id.*; see MARSHALL & ELLIS, *supra* note 5, at 166-67 (discussing validity of efficient market hypothesis).

331. See BLACK'S LAW DICTIONARY 104 (6th ed. 1990). Arbitrage is defined as "[t]he simultaneous purchase in one market and sale in another of a security or commodity in hope of making a profit on price differences in the different markets." *Id.*

332. See BODIE, *supra* note 48, at 99-101 (discussing concept of short sales). In a

listed on U.S. securities exchanges.³³³ Regulation S, in effect, grants offshore investors a guaranteed profit that is not available to U.S. investors because U.S. investors cannot participate in a Category Two Regulation S offering.³³⁴

An example of this phenomenon occurred in April 1993 when Primerica, now Travelers, Inc., sold seven million shares in a Regulation S offering without informing its domestic shareholders.³³⁵ The shares were sold at a nine percent discount to the market price,³³⁶ and the day after the offering was completed, after U.S. traders³³⁷ had heard rumors that the Regulation S distribution had occurred,³³⁸ the stock fell from US\$46.125 to US\$42.75 on triple its average daily volume.³³⁹ During this trading session, in response to a request from the New York Stock Exchange, Primerica announced that it had sold shares pursuant to Regulation S.³⁴⁰ Because the offer and sale

short sale, an investor sells borrowed securities in the belief that the price of the borrowed securities will decline. *Id.* at 99. Later, the borrower replaces the securities with new shares. *Id.* If the share price has declined during the interim, the borrower profits from the difference between the price of the securities at the time they were initially borrowed and sold, and the market price of the replacement shares. *Id.* at 100.

333. See Cohen, *supra* note 18, at C1 (discussing European investors' ability to lock-in profits by using Regulation S stock to cover short sales of U.S. listed stock).

334. See *supra* notes 175-213 and accompanying text (discussing issuer safe harbor procedures of Regulation S). U.S. persons cannot participate in Regulation S offerings due to the restricted periods imposed on offshore offers and sales of Category Two shares. Regulation S, 17 C.F.R. § 903(c)(2) (1994).

335. See Cochran, *supra* note 288, at 68 (discussing European investors' use of Regulation S shares to cover U.S. short sales of Primerica stock). A similar type of profit lock-in probably took place in September 1994. Thomas Cochran, *The Striking Price: A Rush For Conversions*, BARRON'S, Sept. 26, 1994, at MW13 [hereinafter *Conversions*]. In that case, offshore investors bought options to put shares of a small U.S. company called Interactive Network from investors in the United States. *Id.* A put option allows its holder to sell certain securities at a specified price within a specific time period. BODIE, *supra* note 48, at 619. One of the market-makers on the Chicago Board Options Exchange believes that the buyers bought the put options to lock-in profits on shares of Interactive Network that they had bought at a discount in a Regulation S offering. *Conversions* at MW13.

336. Cohen, *supra* note 18, at C1.

337. See MARSHALL & ELLIS, *supra* note 5, at 141-70 (discussing trading practices). A trader is a professional investor who takes, buys, and sells financial instruments in order to earn profits from price changes or a discrepancy in prices asked or offered on different securities markets. *Id.* at 141.

338. Cochran, *supra* note 288, at 68.

339. *Id.*

340. *Id.* Primerica only announced its sale of Regulation S stock after being pressured by the New York Stock Exchange. *Id.* Primerica stated that it did not announce the Regulation S distribution prior to the completion of the offer and sale because it

had already been completed, however, it was too late to prevent European investors who had subscribed to the offering from using the discounted Regulation S shares to cover their short sales.³⁴¹ The European investors were, therefore, able to turn a large, guaranteed profit that was not available to U.S. investors.³⁴²

The use of Regulation S shares by offshore investors to cover short sales of securities sold on U.S. markets poses three problems for U.S. securities market regulators. First, it provides an unfair advantage to non-U.S. investors and, thereby, leads to flowback.³⁴³ Second, offshore investors' use of Regulation S shares to cover short sales may amount to insider trading.³⁴⁴ Finally, the ability of U.S. corporations to avoid announcing Regulation S offerings, which enables offshore investors to undertake these short sale schemes, makes U.S. markets less efficient.³⁴⁵

believed that doing so would violate the prohibition against "directed selling efforts" in the United States. *Id.*; see *supra* notes 169-73 (discussing prohibition on directed selling efforts contained in Regulation S).

341. See Cohen, *supra* note 18, at C1 (discussing European investors' use of Regulation S shares to cover U.S. short sales of Primerica stock).

342. *Id.*

343. See *supra* notes 327-42 (discussing deleterious effects of use of Regulation S shares by offshore investors to cover short sales of U.S. listed stock).

344. See *Conversions*, *supra* note 335; at MW13 (discussing possibility that use of Regulation S shares to cover U.S. short sales may be insider trading). The theory of fraud on the market, which was adopted by the Supreme Court in *Basic, Inc. v. Levinson*, holds that, if markets are efficient, investors have the right to rely on the integrity of the market price. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (discussing and applying theory of "fraud on the market" to insider trading). By accepting the theory of "fraud on the market," the Supreme Court drastically expanded the extent of the securities fraud action for investors who had been induced to sell or purchase securities through misstatements made by the other party to the purchase or sale. Johnathan R. Macey et al., *Fraud on Inefficient Markets: An Economic and Legal Analysis of a Plaintiff's Right to an Unbiased Market Price* i (Feb. 19, 1991) (on file with the New York University Law Library). The authors argue that, even on inefficient markets, investors are entitled to an unbiased estimate of a security's fundamental value. *Id.* at 3.

345. See Mark S. Bergman & Christine M. Alvarez, *SEC Announces Additional International Initiatives*, *INSIGHTS*, June 1994, at 29 (discussing issuers' concerns that Regulation S' prohibition against directed selling efforts prevents them from updating investors about material developments).

III. ENFORCEMENT OF THE SECURITIES ACT REGISTRATION
 REQUIREMENTS UNDER THE REGULATION S
 REGIME: AN ANALYSIS OF THE
 PROBLEMS AND POTENTIAL
 SOLUTIONS

The SEC's adoption of Regulation S in 1990 has benefitted issuers, but harmed the U.S. disclosure regime. On one hand, it has increased the capability of U.S. corporations to compete for capital in the international financial markets.³⁴⁶ On the other hand, Regulation S has made it more difficult for the SEC to track offshore distributions, because issuers no longer feel compelled to request no-action approval each time they issue securities offshore.³⁴⁷ In addition, Regulation S has increased unscrupulous companies' use of the offshore markets to evade registration,³⁴⁸ and significantly lowered the general level of protection against flowback that had previously been the touchstone of SEC policy on offshore issuance and sales.³⁴⁹ After four years of Regulation S, it has become clear that its procedures cause, rather than inhibit, flowback,³⁵⁰ and that Preliminary Note 2³⁵¹ limits the effectiveness of Regulation S as a planning tool for reputable

346. See *supra* notes 256-62 and accompanying text (discussing how Regulation S has increased U.S. issuer access to offshore markets).

347. See *supra* notes 127-35 and accompanying text (discussing U.S. issuers' sense that, prior to adoption of Regulation S, they had to seek approval from SEC of their offshore issuance procedures for each offshore offering to prevent imposition of sanctions); see also J. William Hicks, *Securities Regulation: Challenges in the Decades Ahead*, 68 IND. L.J. 791, 804 (1993) (discussing problems in international enforcement of U.S. securities laws).

348. See *supra* notes 298-304 and accompanying text (discussing evidence of evasive use of Regulation S).

349. See *supra* notes 115-33 and accompanying text (discussing SEC's approach to offshore application of Securities Act registration requirements prior to adoption of Regulation S). Since the SEC began soliciting comment letters prior to adopting new rules and regulations two decades ago, it has become much more responsive to the concerns of issuers, investment banks and brokers, its most vocal constituency. Aply demonstrating this responsiveness is the fact that the commission initially proposed a restricted period of 90 days for all securities in Category Two, and 90 days for debt securities in Category Three. Proposed Rules, 53 Fed. Reg. 22,661, 22,670-72 (June 17, 1988) (discussing safe harbor restricted periods as initially proposed). After receiving 139 comment letters, however, the SEC finally adopted the significantly shorter period of 40 days for those securities. Adopting Release, 55 Fed. Reg. 18,306, 18,307 nn.3, 5 (May 2, 1990); see *supra* notes 195-213 and accompanying text (discussing transactional restrictions imposed by issuer safe harbor provisions).

350. See *supra* notes 14-15 and accompanying text (defining flowback).

351. See *supra* note 237 and accompanying text (discussing Preliminary Note 2).

U.S. companies that wish to sell their securities offshore.³⁵² Due to resource constraints, neither SEC enforcement, nor currently existing private remedies, can solve the flowback problems.³⁵³ In order to bring Regulation S into line with the protective intent of the Securities Act and provide greater certainty for issuers, the SEC must turn the regulation into a self-enforcing mechanism.³⁵⁴ The Commission can make a number of changes in the rules to achieve this aim. These revisions include longer safe-harbor restricted periods, the imposition of more stringent transactional restrictions on issuers and offshore purchasers,³⁵⁵ the provision of an effective private remedy for U.S. buyers of Regulation S securities,³⁵⁶ and the repeal of Preliminary Note 2.³⁵⁷

A. Why the Restrictions Imposed by Regulation S Encourage Flowback

Regulation S was structured to limit flowback and to promote offers and sales primarily to long-term offshore investors through the imposition of various offering and transactional restrictions.³⁵⁸ Unfortunately, the restrictions appear to have done little to dissuade international investors from reselling their shares to U.S. persons,³⁵⁹ with or without a valid exemption, as

352. See *supra* notes 124-26 and accompanying text (discussing and defining "coming to rest").

353. See Hicks, *supra* note 347, at 803 (discussing effect that limited resources will have on SEC's ability to enforce securities laws in future). Lack of resources will hamper the SEC's ability to do its job properly. *Id.* Therefore, the success of offshore enforcement is contingent upon adequate funding by the U.S. Congress. *Id.* With the new Republican majority in place, it is more likely than not that the U.S. Congress will curtail securities industry regulation. See generally Diana B. Henriques, *Republicans May Hold Down the S.E.C. and Investor Suits*, N.Y. TIMES, Dec. 12, 1994, at A1.

354. For Regulation S to become "self-enforcing," it must contain rules which place a greater onus on Regulation S issuers and investors to prevent violations of the safe harbor procedures. New rules must also make it easier for the SEC to follow the movement of Regulation S securities than is presently possible.

355. See *supra* notes 195-213 and accompanying text (discussing transactional restrictions imposed under issuer safe harbor provisions).

356. See *supra* notes 100-05 and accompanying text (discussing private remedy currently available under § 12(1) of Securities Act).

357. See *supra* notes 237-38 and accompanying text (discussing Preliminary Note 2 to Regulation S).

358. See Cohen, *supra* note 18, at C1 (discussing SEC's reasons for adopting Regulation S); see *supra* notes 195-213 and accompanying text (discussing transactional restrictions imposed by issuer safe harbor provisions).

359. See *supra* note 123 and accompanying text (discussing concept of U.S. person under Regulation S and Release 4708). The concept of "U.S. person" under Regulation

soon as the various restricted periods have expired.³⁶⁰ This type of flowback, especially of Category Three securities, is the result of the SEC's abrogation of its duty, mandated by the Securities Act, to protect U.S. investors.³⁶¹

1. The Paradox of the Issuer Safe Harbors

Both the Category Two and Category Three safe harbors³⁶² restrict resales of Regulation S securities for a period of time after the completion of a Regulation S offering.³⁶³ These restrictions, however, give only short-term protection to U.S. investors. Because the restrictions imposed on offshore offers and sales force U.S. issuers to sell overseas at a discount to the U.S. market price for the securities,³⁶⁴ the regulation actually encourages investors in Category Two securities³⁶⁵ to sell their holdings immediately upon the expiration of the restricted period in order to lock in profits.³⁶⁶ Due to the fact that local markets remain the greatest source of demand for the securities of their own nation's companies,³⁶⁷ the U.S. domestic market provides the most likely arena for offshore purchasers of Regulation S securities to

S includes U.S. citizens and residents anywhere in the world during the restricted periods. See Proposed Rules, 53 Fed. Reg. 22, 661, 22,665 (June 17, 1988). Coincident with the SEC's new geographic approach to offshore application of the Securities Act, the Regulation S concept of "U.S. person" includes only people in the United States once the restricted periods have expired. *Id.*

360. See *supra* notes 298-304 and accompanying text (discussing evidence of evasive use of Regulation S).

361. See *supra* notes 81-86 and accompanying text (discussing purpose behind enactment of Securities Act).

362. See *supra* notes 175-213 and accompanying text (discussing restrictions on offshore issuance and sales imposed by Category Two and Three safe harbors).

363. See *supra* notes 195-213 and accompanying text (discussing transactional restrictions imposed by issuer safe harbor provisions).

364. See *supra* note 267 and accompanying text (discussing discounted pricing of Regulation S securities).

365. See *supra* notes 178-79 and accompanying text (describing securities included in Category Two).

366. See *supra* notes 335-42 and accompanying text (discussing use of Regulation S stock to cover short sales of listed securities). The discounts almost automatically lock in profits for Regulation S investors by providing a guaranteed spread between their cost and the U.S. market price. See *supra* notes 327-34 and accompanying text (discussing how use of Regulation S shares to cover short sales allows offshore investors to lock in profits).

367. See U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 1994 527 (tbl. 811) (1994). New Securities offerings by U.S. Corporations totalled US\$339.1 billion in 1990. *Id.* International equity and bond offerings totalled only US\$249 billion in 1990. GOLDSTEIN, *supra* note 42, tbls. 6-7.

resell them.³⁶⁸

Whereas flowback of Category Two securities is not particularly onerous, flowback of Category Three securities represents a direct attack on the protective intent of the disclosure system.³⁶⁹ Even accepting the notion that, despite the potential problems, non-reporting³⁷⁰ U.S. corporations should be allowed to offer their securities on the offshore markets,³⁷¹ the relatively short restricted periods of the Category Three safe harbor do not coincide with the SEC's goal to promote long-term offshore investment in U.S. companies.³⁷² Furthermore, the short restricted periods provide a window of opportunity for offshore purchasers, through unscrupulous or unknowledgeable U.S. brokers, to sell Regulation S securities to unsophisticated U.S. investors.³⁷³

In addition to the current flowback problems caused by Regulation S, the short 40-day and one-year restricted periods contained in Category Three of the issuer safe harbor is inconsistent with the SEC's position, contained in Securities Act Rule 144,³⁷⁴ that informed purchasers of unregistered securities must assume the economic risks of their investment.³⁷⁵ Rule 144's embodiment of this philosophy is the two-year holding period it prescribes for securities bought by investors in reliance on the private placement exemption.³⁷⁶ In contrast, Regulation S, by allowing resale of unregistered securities to U.S. persons on the day immediately following the expiration of the one year re-

368. See STATISTICAL ABSTRACT, *supra* note 367, at 527 (tbl. 811).

369. See *supra* notes 290-97 (discussing why flowback undermines protective intent of Securities Act).

370. See *supra* note 161 and accompanying text (defining reporting issuer).

371. See *supra* notes 284-344 and accompanying text (discussing problems caused by adoption of Regulation S).

372. Cohen, *supra* note 18, at C1.

373. See *supra* notes 73-86 (discussing history and purpose of Securities Act).

374. 17 C.F.R. § 230.144.

375. See *id.* prelim. n. (discussing philosophy underlying Rule 144). The preliminary note to Rule 144 states as follows:

A holding period prior to resale is essential . . . to assure that those persons who buy under a claim of a Section 4(2) [Private Placement] exemption have assumed the economic risks of investment, and therefore are not acting as conduits for sale to the public of unregistered securities, directly or indirectly, on behalf of an issuer.

Id.

376. See *supra* notes 222-23 (discussing restrictions on resales of privately placed securities contained in Rule 144).

stricted period,³⁷⁷ enables offshore investors to cut the economic risks they would have to accept under Rule 144 at least in half. Furthermore, Regulation S, unlike Rule 144, does not mandate that material financial information be available prior to the resale of the unregistered securities.³⁷⁸

Despite the fact that there is little substantive difference between Regulation S securities and privately placed securities, there is a great difference in the way they are sold.³⁷⁹ Under Regulation D, offers and sales of privately placed securities exceeding US\$5 million may not be made to the general public,³⁸⁰

377. 17 C.F.R. § 230.903(c)(3).

378. See 17 C.F.R. §§ 230.901-230.904. The availability of Rule 144 is predicated on the availability of adequate public information regarding the issuing company. 17 C.F.R. § 230.114 *prelim. n.*

379. See *supra* notes 140-250 and accompanying text (discussing provisions of Regulation S); see also JENNINGS, *supra* note 1, at 322-76 (discussing private placement mechanisms).

380. Regulation D — Rules Governing the Limited Offer and Sale of Securities without Registration under the Securities Act of 1933, 17 C.F.R. §§ 230.501-230.508 (1994). Rule 506(b)(2)(ii) states as follows:

Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) [must have] such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.

Id. § 230.506(b)(2)(ii). Regulation D defines "accredited investor" as follows:

(a) "Accredited investor" shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank . . . or any savings and loan association . . . ; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company . . . ; any investment company . . . ; any Small Business Investment Company licensed by the U.S. Small Business Administration . . . ; any [government pension plan], if such plan has total assets in excess of \$5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary . . . or registered investment adviser . . . ;

(2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940; . . .

(4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

(5) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000;

(6) Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a

must not be sold to more than thirty-five persons,³⁸¹ and must not be offered, sold, or resold unless material information substantially the same as that required in a registered public offering is provided to all non-accredited³⁸² purchasers.³⁸³ Regulation S, on the other hand, places few limits on the type of purchasers to whom securities can be sold, no limits on the number of purchasers, and no requirement that material information be made available to those purchasers.³⁸⁴ Regulation S securities can, therefore, be distributed and resold far more quickly, easily, and widely than the same security if it is privately placed.³⁸⁵

Private placements have historically been the primary mechanism for offerings of the unregistered securities of private companies.³⁸⁶ Because, however, the SEC's private placement procedures place significantly greater limitations on sales of securities than does the current Regulation S,³⁸⁷ the danger now exists that many non-reporting U.S. companies will begin to use Regulation S as an alternative to private placements. There are no limits on the number of offshore investors who can participate in a Regulation S offering,³⁸⁸ and no restrictions on the number of Regulation S shares that offshore purchasers can resell to U.S. persons in offshore transactions. Therefore, Regulation S creates the potential for virtually unlimited flowback of unregis-

reasonable expectation of reaching the same income level in the current year;

(7) Any trust, with total assets in excess of \$5,000,000 . . . ;

(8) Any entity in which all of the equity owners are accredited investors.

Id. § 230.501(a).

381. *Id.* § 230.506(b)(2)(i). The issuer need only reasonably believe that it is selling to no more than thirty-five persons to comply with this rule. *Id.*

382. *See supra* note 380 (defining accredited investor).

383. *See* 17 C.F.R. § 230.502(b) (discussing information requirements under Regulation D); *see also* 17 C.F.R. § 230.144(c) prelim. n. (discussing information requirements for resales of privately placed securities under Rule 144).

384. *See supra* notes 140-250 and accompanying text (discussing provisions of Regulation S).

385. *See supra* notes 222-23 and accompanying text (discussing the limitations on resales of privately placed securities imposed by SEC Rule 144).

386. *See* Jeffrey B. Tevis, *Asset-Backed Securities: Secondary Market Implications Of SEC Rule 144A And Regulation S*, 23 *Pac. L.J.* 135, 153 (1991). In 1989, 2407 U.S. issuers privately placed over US\$169 billion worth of securities. *Id.* tbl. 3.

387. *See supra* notes 375-84 and accompanying text (discussing restrictions on issuance and resale of privately placed securities).

388. *See supra* notes 185-213 and accompanying text (discussing offering and transactional restrictions of Regulation S).

tered U.S. corporate securities in the near future.³⁸⁹ In order to defend the disclosure regime created by the Securities Act and the Securities Exchange Act, the SEC must not allow the private placement market to be supplanted by the Regulation S market.

2. Potential Misuse of the Resale Safe Harbor

Although the resale safe harbor³⁹⁰ does not allow officers and directors to serve as conduits for transactions by persons not authorized to utilize the resale safe harbor,³⁹¹ it provides a tempting loophole in the registration requirements by allowing unrestricted offshore sales on secondary markets.³⁹² As a result, careful directors and officers of non-reporting companies can sell their securities in offshore transactions, and those securities, unlike offers under the issuer safe harbor, can immediately flow back to the United States in full compliance with the offshore exemption.³⁹³ Even small indirect distributions by officers of U.S. corporations may open up a Pandora's box of threats to the registration regime and, by extension, the disclosure system developed by the SEC.³⁹⁴

B. *Why Private Remedies and Stepped-Up SEC Enforcement Will Not Solve the Flowback Problem*

The SEC Division of Enforcement³⁹⁵ ("Enforcement") has

389. See *supra* notes 305-14 and accompanying text (discussing methods of flowback).

390. Regulation S, 17 C.F.R. § 230.904 (1994).

391. See Adopting Release, 55 Fed. Reg. 18,306, 18,319 (May 2, 1990) (discussing limits on use of resale safe harbor by corporate officers).

392. See *supra* notes 214-34 and accompanying text (discussing provisions of resale safe harbor). The resale safe harbor is available for the offshore sale of any security, not just Regulation S securities. Adopting Release, 55 Fed. Reg. 18,306, 18,319.

393. See *supra* notes 305-14 and accompanying text (discussing methods through which Regulation S securities can flow back into United States). The safe harbors are not exclusive, and do not affect the availability of any other exemption from the registration requirements of the Securities Act. Adopting Release, 55 Fed. Reg. 18,306-08.

394. See *supra* notes 290-97 (discussing why flowback threatens Securities Act disclosure regime).

395. See U.S. GENERAL ACCOUNTING OFFICE, STATISTICS ON SEC'S ENFORCEMENT PROGRAM 1-3 (1985) (discussing structure and methods of SEC Division of Enforcement). The Enforcement Division of the Securities Exchange Commission consists of attorneys whose job is to investigate potential violations of the U.S. securities laws and regulations and bring suit, either administratively or in federal court, against those found to be in violation. *Id.*; see *supra* notes 106-12 and accompanying text (discussing statutory basis for SEC enforcement activities).

begun to scrutinize Regulation S distributions much more closely over the past year than it had in the first three years the regulation was in effect.³⁹⁶ Despite this heightened level of investigatory interest, the SEC has not brought a case for a Regulation S violation since *Westdon*³⁹⁷ in 1990.³⁹⁸ Due to the difficulty of both discovering and proving that a Regulation S violation has occurred, neither enforcement by the SEC³⁹⁹ nor the private remedy granted by Securities Act section 12(1)⁴⁰⁰ are likely to be effective in ameliorating the flowback problem.

1. The Difficulties Confronting the Securities and Exchange Commission in Regard to Offshore Enforcement Actions

There are three major reasons why SEC enforcement measures will not deter flowback of Regulation S securities. First, the SEC's enforcement resources are limited.⁴⁰¹ Furthermore, over the last decade, the SEC has considered enforcement of the registration laws of secondary importance to the battle against insider trading and broker/dealer violations.⁴⁰² Second, because neither Regulation S issuers nor offshore investors need to re-

396. Telephone Interview with Michael Hyatt, SEC Office of International Finance (Sept. 22, 1994).

397. See *supra* notes 315-21 and accompanying text (discussing facts and results of *Westdon* case).

398. Telephone Interview with Michael Hyatt, SEC Office of International Finance (Sept. 22, 1994).

399. See Hicks, *supra* note 347, at 804 (discussing difficulty of international enforcement of U.S. securities laws). International enforcement brings with it a multiplicity of problems, including issues concerning gathering of evidence, service of process, freezing of overseas assets, and enforcement of U.S. judgments against offshore violators. *Id.*

400. Securities Act of 1933 § 12(1), 15 U.S.C. § 771-1; see *supra* notes 100-05 and accompanying text (discussing private remedy granted by Section 12(1) of Securities Act).

401. See Hicks, *supra* note 347, at 802-03 (discussing whether SEC enforcement resources will be sufficient to deal with regulation of international transactions).

402. See Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation By Enforcement: A Look Ahead At The Next Decade*, 7 YALE J. ON REG. 149, 200-01 (1990). Throughout the 1980's, insider trading was the primary focus of the SEC Division of Enforcement. *Id.* Since the beginning of this decade, the SEC has utilized its resources primarily to attack insider trading, financial fraud and other similar reporting violations, market manipulation, and securities offering violations. William R. McLucas et al., *SEC Enforcement: A Look At The Current Program And Thoughts About The 1990s*, in 2 23RD ANNUAL INSTITUTE ON SECURITIES REGULATION, at 283, 285 (PLI Corp. L. Practice Course Handbook Series No. B4-6978, 1991). It is hard, however, to determine what priority the SEC will give to enforcement of offering violations in the 1990's. *Id.* at 308.

port offshore sales to the SEC, it is extremely difficult for the Commission to monitor the legality of Regulation S deals.⁴⁰³ Third, in order to win sanctions for a Preliminary Note 2 violation, which entails the use of Regulation S as part of a scheme to evade the Securities Act registration requirements,⁴⁰⁴ the SEC must prove intent.⁴⁰⁵ Because it is difficult for Enforcement to develop evidence if the transaction occurs outside of the United States, as long as the parties to an offshore deal conform to the requirements of Regulation S the SEC will have great difficulty collecting proof that the parties to the transaction intentionally used the regulation in an evasive manner.⁴⁰⁶ These constraints limit the SEC's ability to operate effectively in the international arena. Therefore, Regulation S must be amended to help the SEC track the movement of Regulation S securities.

Use of Regulation S to evade the registration rules will rarely be as apparent as in the *Westdon* case.⁴⁰⁷ As a result, even if Enforcement discovers evidence that a Regulation S violation has occurred, the SEC will generally find it either impossible or

403. See Richard M. Phillips et al., *The Internationalization of Securities Fraud Enforcement in the 1990s*, in 2 23RD ANNUAL INSTITUTE ON SECURITIES REGULATION, at 381, 385 (PLI Corp. L. Practice Course Handbook Series No. B4-6978, 1991) (discussing ability of participants in offshore transactions to hide their identities from SEC). It is extremely difficult for the SEC to enforce U.S. securities laws in the context of international fraud for a number of reasons. *Id.* at 386-88. First, obtaining subject matter or personal jurisdiction over an alleged violator may be not be possible. *Id.* Second, serving process over the alleged violator may also prove impossible. *Id.* Third, it may be hard to gather evidence outside of the United States due to secrecy and blocking laws, and a dearth of witnesses willing to testify. *Id.* Fourth, the SEC may not be able to find and seize ill-gotten gains. *Id.* Finally, differences in bookkeeping and disclosure requirements between countries may render the actions of offshore violators nearly incomprehensible to SEC investigators. *Id.*

404. See *supra* notes 237-38 and accompanying text (discussing preliminary note 2 to Regulation S).

405. See Adopting Release, 55 Fed. Reg. 18,306, 18,308 (May 2, 1990) (discussing anti-evasion rule of Regulation S). Preliminary Note 2 allows the SEC to investigate and sanction participants in a Regulation S transaction who are in technical compliance with the rules if the Commission believes that the purpose of the transaction was to evade the Securities Act registration requirements. Regulation S, 17 C.F.R. §§ 230.901-230.904 *prelim. n.2.*

406. See *supra* note 401-05 and accompanying text (discussing difficulty of enforcing U.S. securities laws in context of international transactions).

407. *Securities and Exchange Commission v. Westdon Holding & Investment, Inc. et al.*, Litigation Release No. 13,263, 1992 WL 136673 (S.E.C.) (June 5, 1992); see *supra* notes 315-21 and accompanying text (discussing facts and results of *Westdon* case).

fiscally prohibitive to build a case against the violator.⁴⁰⁸ Consequently, under Regulation S as currently configured, if the SEC gains knowledge of illicit flowback of Regulation S securities into the United States, Enforcement may be able to undertake proceedings against U.S. issuers who intentionally use Regulation S to violate the Securities Act registration requirements.⁴⁰⁹ The Commission may also be able to sanction U.S. securities dealers who make illegal redistributions possible. It will generally not, however, be able to undertake enforcement proceedings against offshore investors, who are the apparent source of many, if not most, Regulation S violations.⁴¹⁰ Because the SEC has demonstrated a tendency to accept injunctive relief for all but the most egregious securities law violations,⁴¹¹ it is unlikely that the Commission will be able to deter others, especially non-U.S. citizens, from illegally using Regulation S in money-making schemes.

2. Private Remedies

In the case of Regulation S violations, the private remedy granted by Section 12(1) of the Securities Act provides little protection against flowback for U.S. investors for a number of reasons.⁴¹² First, the non-underwriter exemption does not require the seller to inform his or her buyer that the securities are Regulation S securities.⁴¹³ Nor does Regulation S mandate disclosure once the restricted period has expired.⁴¹⁴ As a result, the buyer may never know that the securities that he or she purchased were unregistered Regulation S securities. Second, even if the U.S. investor can prove a registration violation, his or her legal

408. See *supra* notes 401-06 and accompanying text (discussing constraints against SEC enforcement of Regulation S).

409. See *supra* notes 106-12 (discussing investigatory and sanctioning powers of SEC).

410. See *supra* notes 315-42 (discussing *Westdon* case and use of Regulation S shares to cover short sales).

411. See UNITED STATES SECURITIES AND EXCHANGE COMMISSION, 1993 ANNUAL REPORT 1 (1994). The SEC brought 401 injunction and administrative proceedings in 1993. *Id.* In contrast, only sixty-seven criminal indictments for securities law violations were obtained in 1993. *Id.*

412. See *supra* notes 100-05 and accompanying text (discussing private remedy granted by Section 12(1) of Securities Act).

413. See *supra* note 82 and accompanying text (discussing non-underwriter exemption at Section 4(1) of Securities Act).

414. See *supra* notes 214-34 and accompanying text (discussing compliance procedures necessary to qualify for resale safe harbor protection under Regulation S).

costs may render the suit worthless.⁴¹⁵ Finally, under Section 12(1) a purchaser of unregistered securities may only sue the person or entity from whom he or she bought the securities.⁴¹⁶ Locating the seller, especially if he or she is a non-U.S. person, may prove impossible. Because Section 12(1) does not provide the unwitting U.S. purchaser of Regulation S securities with any recourse to the issuer, Section 12(1) will generally provide no remedy at all.⁴¹⁷ Regulation S, therefore, denies U.S. investors the protection to which they would otherwise be legally entitled.⁴¹⁸

C. Recommendations for Diminishing the Flowback Problem⁴¹⁹

The SEC must develop an offshore exemption regime that promotes a rational balance between the U.S. government's desire to provide free access to the international securities markets for U.S. companies and the maintenance of adequate safeguards against flowback.⁴²⁰ Regulation S does not currently provide that balance. Neither SEC enforcement nor extant private remedies can prevent unwanted flowback of Regulation S securi-

415. See Securities Act of 1933 § 12(1). Section 12(1) does not provide costs and attorney's fees for the winning party. *Id.*; see *supra* notes 100-05 and accompanying text (discussing private remedy granted by Section 12(1) of Securities Act).

416. *Pinter v. Dahl*, 486 U.S. 622, 647 (1988).

417. See *supra* note 105 and accompanying text (discussing lack of issuer liability to subsequent purchasers under § 12(1) of Securities Act).

418. See *supra* notes 73-86 (discussing underlying philosophy and purpose of Securities Act); see also Fleming, *supra* note 267, at 13 (discussing danger of flowback to U.S. investors). The market for Regulation S issues is so risky that unwary investors can be easily cheated. *Id.*

419. Section III(C) presupposes three propositions. First, the SEC has an unwavering duty to protect U.S. investors in the United States against distributions of non-exempt, unregistered securities. See *supra* notes 73-86 and accompanying text (discussing underlying purpose and philosophy of Securities Act). Roberta S. Karmel, a former SEC commissioner and advocate of regulatory reform, argues that investor protection remains extremely important because it promotes private investment in the economy through securities purchases. KARMEL, *supra* note 84, at 298. Second, the SEC should not promulgate rules that give non-U.S. investors advantages that U.S. investors do not have, such as the ability of offshore investors to use Regulation S stock to cover U.S. short sales. See *supra* notes 326-44 and accompanying text (discussing use of Regulation S stock to cover short sales on U.S. exchanges). Third, most detrimental flowback of Regulation S shares will either comply with SEC rules or be untraceable. See *supra* notes 401-11 and accompanying text (discussing constraints against SEC enforcement of Regulation S).

420. See *supra* notes 134-39 and accompanying text (discussing reasoning behind SEC's adoption of Regulation S).

ties.⁴²¹ To solve the flowback problem, the SEC must structure any future approach to regulation of offshore securities issuance in a fashion that will use market forces to render the rules self-enforcing. The SEC should, therefore, consider the following suggestions for revising Regulation S in order to ensure that U.S. investors receive the protection to which they are entitled under the Securities Act.⁴²²

1. Changes to Limit Flowback of Category Two Securities

Flowback of Category Two securities⁴²³ represents only a limited threat to U.S. investors.⁴²⁴ Therefore, the SEC need not take drastic measures to cut off the flow of those securities. A few changes, however, are warranted. First, the SEC should consider increasing the length of the Category Two holding period.⁴²⁵ This step would discourage flowback by making it much more difficult for international investors to use Regulation S shares to cover U.S. short sales with Regulation S securities,⁴²⁶ thereby removing a major incentive for short-term speculators to purchase Regulation S issues. This action would, however, decrease the liquidity of Category Two stocks, and possibly lead to a tightening of the offshore market for the affected shares.⁴²⁷ As a

421. See *supra* notes 395-418 and accompanying text (discussing constraints on use of enforcement mechanisms and private remedies to combat flowback of Regulation S securities).

422. See *supra* notes 73-86 and accompanying text (discussing underlying purpose and philosophy of Securities Act). Because investors in corporate debt tend to be sophisticated in comparison with most equity investors, and are therefore less likely to be harmed by flowback, the suggestions below deal primarily with changes to the rules affecting the offshore distribution of stock. See Adopting Release, 55 Fed. Reg. 18,306, 18,318 (May 2, 1990) (discussing why SEC has placed greater transactional restrictions on Category Three debt than on Category Three equity).

423. See *supra* notes 178-79 and accompanying text (discussing securities contained in Category Two of issuer safe harbor).

424. See Adopting Release, 55 Fed. Reg. 18,306, 18,316 (discussing SEC concerns about flowback of Category Two securities). In the event of flowback, the information available due to the Exchange Act reporting requirements should ensure investor protection. *Id.*

425. See Regulation S, 17 C.F.R. § 230.903(c)(2)(iii) (1994). Currently, the holding period is 40 days. *Id.*; see *supra* note 196 and accompanying text (discussing restricted period imposed for Category Two offers and sales).

426. See *supra* notes 326-44 and accompanying text (discussing use of Regulation S stock to cover short sales on U.S. exchanges).

427. See BODIE, *supra* note 48, at 893 (discussing concept of liquidity). Investors who need to sell assets on short notice may not include illiquid assets in their portfolio. *Id.*

result, U.S. issuers may have to increase the discount to U.S. market price given to offshore investors.⁴²⁸ If the issuer is a major corporation whose shares are in demand, however, lengthening the Category Two holding period should not significantly hinder the company's ability to issue offshore.

The second revision the SEC should consider is the imposition of restrictions on the size of the discount to U.S. market price at which Regulation S securities can be issued.⁴²⁹ This limitation would affect the market for the securities in a similar fashion to the extension of the restricted period.⁴³⁰ Because this rule would require the SEC to interfere directly in the operation of the market, U.S. corporations and the financial community would almost certainly adamantly oppose this approach to the problem.

Finally, in the interest of promoting equal access to material information for both U.S. and offshore investors, Regulation S should be revised to require that reporting U.S. issuers announce Regulation S offerings in the United States prior to the commencement of all offshore offerings.⁴³¹ Currently, Regulation S issuers may disclose the terms of an offer in the United States without violating the regulation's general⁴³² and offering⁴³³ restrictions, but they are not required to do so.⁴³⁴ Mandatory announcements of Regulation S distributions prior to the offer and sale will not place U.S. issuers in a worse finan-

428. See *supra* notes 266-67 and accompanying text (discussing effect of safe harbor transactional restrictions on pricing of Regulation S issues).

429. See *supra* notes 326-44 and accompanying text (discussing use of Regulation S stock to cover short sales on U.S. exchanges).

430. See *supra* notes 426-28 and accompanying text (discussing anticipated results of lengthening Category Two restricted period).

431. See *supra* notes 326-34 and accompanying text (discussing potential effect of failure to announce Regulation S offering on U.S. market price).

432. 17 C.F.R. § 230.903(a)-(b); see *supra* notes 166-74 and accompanying text (discussing general restrictions of Regulation S safe harbors).

433. 17 C.F.R. § 230.902(h); see *supra* notes 187-94 and accompanying text (discussing offering restrictions imposed on Regulation S issuers).

434. Simplification of Registration and Reporting Requirements for Foreign Companies; Safe Harbors for Public Announcements of Unregistered Offerings and Broker-Dealer Research Reports, Securities Act Release No. 7053 (Apr. 19, 1994). Issuers may now announce Regulation S sales in the United States as long as the announcement explicitly states that the securities have not been offered or sold in the United States and will not be offered or sold in the United States. *Id.* The announcement may only contain very limited information, including the name of the issuer, and the basic terms of the issue. *Id.*

cial position than if they did not announce.⁴³⁵ Furthermore, like the results of the previous suggestions, mandatory announcements will increase the efficiency of the markets, decrease the price of the shares on the domestic exchanges prior to issue, and preclude offshore investors from using Regulation S shares to unfairly cover short sales.

2. Changes to End the Flowback of Category Three Securities

Companies that are not subject to the Securities Exchange Act of 1934 need not comply with the SEC's continuing disclosure requirements.⁴³⁶ As a result, U.S. investors are unlikely to have access to information concerning Category Three securities.⁴³⁷ Accordingly, U.S. investors need significantly greater protection against flowback of Category Three securities than they do against flowback of Category Two securities.⁴³⁸ Whereas the preceding proposals are designed to limit flowback, the following suggestions are designed to completely cut off flowback for the length of time necessary to ensure that the offshore purchaser assumes the economic risk inherent in his or her investment.⁴³⁹

To end injurious flowback of Category Three securities,⁴⁴⁰ the SEC should first increase the length of the Category Three equity holding period from its current length of one year to two years.⁴⁴¹ The SEC, in Rule 144,⁴⁴² has already determined that two years is a sufficient time to ensure that the primary offering purchaser, rather than the U.S. purchaser to whom he or she

435. See generally Myron Scholes, *The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices*, 45 J. Bus. 179 (1972) (discussing pricing effects of large offerings of stock by reporting companies).

436. See Securities Exchange Act § 12(g)(1), 15 U.S.C. § 78l (1988 & Supp. V 1993) (discussing which types of corporations must register securities with SEC).

437. See *supra* notes 183, 198-99 and accompanying text (discussing differing levels of information available concerning Category Three versus Category Two issuers).

438. See Adopting Release, 55 Fed. Reg. 18,306, 18,318 (May 2, 1990) (discussing why restrictions on Category Three securities are greater than those on Category Two Securities).

439. See Rule 144, 17 C.F.R. § 230.144 *prelim. n.* (1994) (discussing purpose of two-year restricted period on resales of privately placed securities).

440. See *supra* note 180 and accompanying text (discussing securities contained in Category Three of issuer safe harbor).

441. See *supra* notes 205-08 and accompanying text (discussing restricted periods for Category Three securities).

442. 17 C.F.R. § 230.144.

resells, accepts the risk of issuer insolvency.⁴⁴³ Extending the restricted period will, therefore, have two positive results. It will force offshore investors in Regulation S stock to hold their shares for the long-term,⁴⁴⁴ and it will bring Regulation S into line with the Rule 144 restricted holding periods on resales of shares bought through U.S. private placements.⁴⁴⁵ Even though a two-year holding period is likely to reduce both the size of the market for the Category Three shares and the primary offering price,⁴⁴⁶ the lack of availability of information about Category Three corporations makes such a restrictive rule necessary.⁴⁴⁷

As a second step, the Commission should mandate that the identification legend,⁴⁴⁸ currently required to be placed on all Category Three securities during the restricted period, remain on the shares until some point after they have been validly resold in the United States under a resale exemption.⁴⁴⁹ Furthermore, the SEC should impose a new requirement that either issuers or offshore purchasers of Regulation S shares report resales to the Commission regardless of whether the Regulation S restricted period has expired. These actions will enable the SEC to more easily trace the flow of unregistered Regulation S stock, and thereby prevent unlawful flowback of such securities into the United States.⁴⁵⁰

Third, the SEC should recommend to the U.S. Congress that it expand the scope of the Section 12(1) private remedy,⁴⁵¹

443. *Id.* § 230.144(d); *see id.* § 230.144 prelim. n. (discussing philosophy underlying Rule 144).

444. *See supra* note 210 and accompanying text (discussing requirement that all Category Three issuers agree by contract with purchaser that they will not transfer securities in violation of Regulation S).

445. 17 C.F.R. § 230.144; *see supra* notes 222-23 and accompanying text (discussing private placement procedures required by SEC Rule 144).

446. *See supra* notes 266-67 and accompanying text (discussing effect of safe harbor transactional restrictions on pricing of, and market for, Regulation S issues).

447. *See* Adopting Release, 55 Fed. Reg. 18,306, 18,318 (May 2, 1990) (discussing reasons why current restrictions on Category Three equity are higher than those imposed on Category Two equity).

448. *See supra* note 209 and accompanying text (discussing identification legend required on Category Three equity securities).

449. *See supra* note 82 and accompanying text (discussing statutory exemptions from registration).

450. *See supra* notes 395-418 and accompanying text (discussing constraints on use of enforcement mechanisms and private remedies to combat flowback of Regulation S securities).

451. Securities Act of 1933 § 12(1), 15 U.S.C. § 77i (1988 & Supp. V 1993); *see*

under rules prescribed by the SEC, to allow rescission by investors in the United States against issuers who distribute on the offshore markets, regardless of whether the purchaser is in privity with the issuer.⁴⁵² The SEC could then grant unwitting U.S. purchasers of Regulation S securities the right to rescind against the issuer at the purchase price, or fair market value on the date of purchase, for a certain period of time after the securities initially flowed back.⁴⁵³ This rule would place the burden of ensuring that flowback did not occur on Category Three issuers instead of the SEC.⁴⁵⁴ As a result, this rule would give substantial protection to U.S. investors, while at the same time, due to the potential costs involved, discourage the use of the Regulation S facility by companies in poor financial shape. This method of flowback limitation is particularly appropriate because it works on market principles.⁴⁵⁵ Issuing corporations could transfer much of the risks of liability by contracting with the offshore investors who purchased the shares in the primary Regulation S offering for indemnification in the event that those securities were sold in the United States prior to the expiration of the liability period. This contractual obligation would, in turn, provide an additional disincentive for offshore investors to engage in activities that could lead to flowback during the restricted period. This rule would not, however, shut off the international markets to unregistered companies for which the SEC has a legitimate interest in allowing access - namely, financially-sound, non-reporting U.S. companies that either cannot afford to make a public offering, or have chosen not to do so for other reasons.

Finally, after taking the preceding steps, the SEC should eliminate Preliminary Note 2,⁴⁵⁶ in order to provide greater certainty for U.S. corporations and offshore investors who abide by the amended rules of Regulation S. Preliminary Note 2 will no

supra notes 100-05 and accompanying text (discussing private remedy granted by Section 12(1) of the Securities Act).

452. *See supra* notes 104-05 and accompanying text (discussing limits on scope of rescission right granted under section 12(1) of Securities Act).

453. *See* Securities Act of 1933 Act § 12(1) (discussing current right of rescission).

454. *See supra* note 180 and accompanying text (discussing securities contained by Category Three).

455. *See* Grundfest, *supra* note 114, at 7-10 (discussing why SEC should apply market principles to securities regulation).

456. *See supra* notes 237-38 and accompanying text (discussing Preliminary Note 2 to Regulation S).

longer be necessary because the combination of longer restricted periods, mandatory announcements, and an effective private remedy will give U.S. citizens and residents reasonable protection against flowback, while still enabling U.S. corporations to compete for offshore capital.⁴⁵⁷ Furthermore, these changes will reduce the amount of scarce enforcement resources that the SEC will have to expend in the future to monitor offshore transactions.⁴⁵⁸

Flowback of Category Three securities poses a great threat to the continuing effectiveness of U.S. securities registration requirements.⁴⁵⁹ The SEC must, therefore, carefully monitor whether the revisions it makes to Regulation S effectively reduce the problem. Over the next few years, the Commission must determine whether maintaining open access to international markets for non-reporting U.S. corporations is truly possible within the framework of the Securities Act.⁴⁶⁰ If the SEC finds that the revisions are ineffective, the Commission should return to the no-action procedures of Release 4708 for non-reporting companies.⁴⁶¹

CONCLUSION

Regulation S represents a noble attempt by the SEC to allow almost unlimited access to offshore funding for U.S. corporations, while still maintaining an adequate shield against flowback of unregistered securities into the hands of unsuspecting U.S. investors. Intent, however, has not become reality. Due to the fact that offshore issuers no longer find it necessary to request no-action letters, Regulation S has impaired the SEC's ability to track offshore distributions and to prevent flowback. After four years in operation, the SEC must recognize that Regulation S, as currently designed, provides too much room for use as an evasive device, and not enough protection for investors. Although

457. See *supra* notes 263-75 and accompanying text (discussing importance of U.S. corporate access to offshore capital).

458. See *supra* note 401 and accompanying text (discussing limitations on SEC enforcement resources).

459. See *supra* notes 290-97 (discussing why flowback undermines protective intent of Securities Act).

460. See Asbill, *supra* note 251, at 8 (discussing need for SEC to determine whether competitiveness in offshore markets should be major concern).

461. See *supra* notes 129-34 and accompanying text (discussing no-action letter process under Release 4708).

it is impossible to determine how much unwanted flowback has occurred since 1990, there have been enough instances to warrant the SEC's attention. Because Regulation S provides a wide conduit through which unregistered securities can easily make their way back to the United States without SEC knowledge, it poses a grave danger to the continuing efficacy of U.S. securities registration law. In order to prevent further leaks in the Securities Act's protective wall, the SEC should adopt the stricter rules set forth above. These changes will restrain unhealthy issuers, but can be made without any undue reduction in market entry for the financially-sound U.S. corporations that Regulation S was originally meant to aid. By providing more definitive rules, the SEC will not only remedy the flowback problem, but will also enable issuers to rely on Regulation S without fear that the SEC might accuse them of scheming to avoid registration. As a result, the SEC will have taken appropriate steps to provide the balance between protection from flowback and access to the offshore markets required to make Regulation S work in the manner that the SEC originally intended.