

SPECIAL PROBLEMS ARISING AS A RESULT OF  
TRADING IN MULTIPLE MARKETS

Charles M. Nathan

MR. HAWES: We will now turn to Chuck Nathan, who is going to deal with some of the problems arising when a security is traded in a number of markets.

1. BARRIERS TO ENTRY INTO THE U.S. SECURITIES MARKETS

MR. NATHAN: We have been talking for most of the day about international securities markets. Although some of the discussion has been in terms of discrete markets, we have also spoken at length about linkages between markets and about internationalization and harmonization among the markets. One of the clear patterns that has emerged from the discussion is a sharp geographical boundary that has been drawn around the U.S. For comparison look at the Eurodollar market today. By and large, the Eurodollar market is a multi-national market, a market that transcends and functions efficiently across national boundaries.

There are a number of factors that have contributed to this situation--if you will, a "fortress America" approach. U.S. tax law is one element that has led to market segregation. One of the important components of the discontinuity between the international Euro-markets and the U.S. domestic market is the U.S. securities laws.

I would like to sketch out the nature of the fence that the U.S. securities laws have built around the domestic U.S. securities markets. The starting point for analysis is the Securities Act of 1933. Although it is not the only securities law one has to deal with in the analysis, it is by far the most important single statute.

2. THE SECURITIES ACT OF 1933 AND U.S. SECURITIES ISSUED ABROAD

A. Jurisdictional Scope

To understand the present situation, one must start with a technical analysis of the Securities Act of 1933. For the sake of simplicity, I will paraphrase and generalize and try not to be too technical. Essentially, the Securities Act of 1933 states that no one may make a public offering of securities, if the offering utilizes an instrumentality of interstate commerce, unless the securities have been registered with the SEC.

The only territorial notion built into this broad prohibition is the idea of interstate commerce, which includes (and it is important to note that it includes) commerce between the U.S. and foreign countries. International telephone calls, international mail,

shipping documents overseas--anything of that sort involves the so-called jurisdictional aspect of the 1933 Act. This is the only part of the Act that speaks specifically to the jurisdictional reach of the statute, which is therefore quite broad.

In addition to the very broad jurisdictional purview of the statute is its very broad notion of distribution. The concept of a public distribution of securities under the 1933 Act goes well beyond what might be termed formal distribution mechanics. When an issuer sells securities to an underwriter under an underwriting agreement, and the underwriter then redistributes those securities--that, in and of itself, may not conclude the distribution. The 1933 Act encompasses a concept (which has been developed by common law, by SEC pronouncement, and by gloss) that the distribution is not completed until the securities reach the hands of the ultimate investor. The identity of that ultimate investor is one of the great unknowns of 1933 Act legal lore.

However, if one looks today at the Eurodollar market and some of the common distribution practices, questions can easily be raised about when the distribution of a given Euro-security issue is really completed. For example, an underwriter may place some of the securities in distribution into a managed account with the intention of pulling those securities back out of the managed account a week later, if the market is favorable, to sell into the U.S. I think most securities lawyers in the U.S. would conclude that the distribution is not completed when the securities go into the managed account--but rather, that it is completed when the securities are resold into the U.S. However, by the act of selling unregistered securities into the U.S., we are invoking the Securities Act of 1933 and creating an illegal, unregistered public distribution within the terms of that Act. It was this analytical starting point that led in large part to the creation of the Eurodollar market.

#### B. SEC Release No. 4708

The key event in the genesis and development of the Eurodollar, Euro-security market was a release that the Securities and Exchange Commission published in 1964--SEC release No. 4708 [1]. This release sets forth a very important principle and, indeed, probably represents a codification of prior SEC staff practice and understanding. Release 4708 states that if someone issues securities, under circumstances reasonably designed to preclude their distribution or re-distribution into the U.S. or to U.S. nationals living abroad, then the Securities and Exchange Commission will not take any enforcement action even if the transactions technically involved the use of a means of interstate commerce.

The release thus is a gloss on the Act--a voluntary adoption of a more narrow concept of the jurisdictional reach of the 1933 Act. The practice that began in 1964 and continues today is an effort to interpret those magic words in Release 4708. What is "reasonably designed to preclude the illegal distribution or re-distribution of securities into the U.S.?"

I find it useful to distinguish between U.S. issuers and foreign issuers. U.S. issuers, as a realistic matter, are subject to SEC jurisdiction in a very concrete way. There is no question that a U.S. issuer has to live with the SEC day in and day out, and cannot afford to take any significant chance of a violation of the 1933

[2]

Act. I think that is the prevailing spirit in the U.S.; it is clearly the advice of virtually every U.S. securities lawyer.

Accordingly, U.S. issuers in the Euro-market have always approached the 1933 Act problem on a conservative basis, acknowledging that compliance is essential. Various techniques have evolved over the years--particularly since the repeal of the interest equalization tax in 1974--to come to grips with Release 4708. These techniques have developed into a so-called ninety day "lock-up", which is described in more detail in the outline appended to this chapter.

### C. The Ninety Day Lock-up

One of the interesting aspects of the ninety day lock-up technique is that, although it was initially sanctioned by no-action letters, its evolution has not similarly been sanctioned. Thus, there are several relatively early no-action letters in which the SEC staff said, in effect, that the staff would not take any action if specified procedures were followed. In so doing, the staff agreed, although it did not so state affirmatively, that the described lock-up procedures were reasonably designed to prevent the illegal distribution of securities into the U.S. Since these 1974-1976 no-action letters there have been a number of developments in the lock-up area. So far as I am aware, however, the new developments have never been presented to the SEC staff.

The original ninety day lock-up procedure contemplated issuance of individual temporary certificates. Each purchaser received his own temporary certificate, which did not have interest coupons attached. The temporary certificate was not exchangeable for the definitive certificate until ninety days after the distribution was completed. The definition of completion was spelled out in the underwriting papers. It required a procedure where every underwriter informed the managing underwriter that his portion of the distribution had been completed. The managing underwriter then reached a determination that the entire distribution was complete, and ninety days was measured from that time. At the conclusion of the ninety day period under the old scheme the individual investors, the non-U.S. investors, would present their temporary certificates for exchange for definitive certificates with the attached interest coupon. As the final measure of protection, each holder was required to certify that he was not a U.S. national or resident.

Somewhere along the line a modified procedure evolved that today is virtually universal. The temporary certificate, which obviously entails a great deal of paperwork and back-office mechanical problems, has been abandoned in favor of a so-called global certificate. A global certificate is issued to a clearing agency, and it cannot be broken up into definitive individual certificates until the magic ninety day period ends. In the meantime, it is possible to trade interests in the global certificate. Nonetheless, at the end of the ninety day period, the holder of such interest, in order to obtain a definitive certificate, must make the requisite certification stating that he is not a U.S. national or resident.

When you get a group of technicians together, lawyers who practice in this area, you could probably argue far into the night as to the relative merits of the two lock-up systems. Which one is better designed to prevent an illegal (that is, unregistered) distribution into the U.S.? The point I want to make is that the decision to switch from the temporary certificate to the global certifi-

cate has been made without consultation of the SEC. That is very characteristic of the practices that have grown up under Release 4708. Individual lawyers--working with their clients--have rendered their own judgments as to what is compliance with Release 4708 and what means are reasonably designed to prevent the illegal distribution of securities into the U.S. This practice has raised a number of serious practical problems.

Lawyers may have different views on the subject. The circumstances of each offering may be very different. When you are practicing in this area, you are continually confronted with the pattern of somebody pulling a document out of his briefcase and saying, "XYZ company did it this way. Why can't we?" And then you have to defend the advice you have given if it is more conservative--which is the only time somebody cites an example like that--and explain why you disagree with the decision that XYZ's lawyers presumably made. Moreover, compliance with the 1933 Act in the context of foreign offerings of securities is an area in which ignorance plays a significant role. Ignorance, lack of sophistication, and relative degrees of conservatism or bravery play important and real roles. Often you see discrepancies in practice that cannot be rationally justified, other than that is the way the world works in practice.

MR. HAWES: Could I interrupt there for just a moment, Chuck? I wanted to ask the two investment bankers, from a marketing standpoint and so forth, what is the effect of the rule? If there were no such flow-back procedure, would more securities come back into the U.S.? What is your feeling about the business context of this problem?

MR. VON CLEMM: As far as we are concerned you can have a three hundred and sixty day lock-up if you want.

MR. HAWES: And that is because they really are being sold to European investors and they are not going to be flowed back anyway?

MR. VON CLEMM: That is our experience.

MR. COLES: I think I would endorse what Michael said, but in the opposite direction. I think the market has become so trained now that Eurobond securities do not come back into the U.S. until after some reasonable seasoning period. You need not have a lock-up at all.

MR. NATHAN: That is probably the reality; it certainly is my impression from my experience in this area. With all the hullabaloo about the lock-up procedures, the difficulties, the mechanical aspects, why do we do it? The reality is that it has had virtually no effect in the market; and compliance is not difficult.

#### D. Equity Issues

There is another important aspect of the lock-up rule--coming back to a comment made earlier in the program--and that is equity offerings in Europe. U.S. issuers can devise lock-up procedures for convertible debt issues, but the flow-back problem (the potential of the security coming back into the U.S.) obviously increases when you switch from a straight debt offering. Debt issues are designed for

European market conditions, designed to be attractive to European investors, and they often are quite different from the type of instrument U.S. investors are looking for. With an equity issue--the prototype is common stock--the flow-back problem probably is not soluble.

How do you prevent common stock of General Motors issued in Europe from flowing back into the U.S.? What devices can you possibly imagine that will be effective to lock-up shares in Europe until their distribution is complete? This may not be the only reason why American companies have not issued common stock in Europe, but it is clearly one of the major reasons. The one no-action letter that exists in this area suggests that a ninety day lock-up is not sufficient. You also must place a restrictive legend on the shares and, perhaps, require approval by counsel for every individual trade involving a U.S. national. That is obviously a procedure that is unworkable in real life.

I would like to suggest that with the movement towards integration utilizing the Form S-16 registration statement, there no longer is a significant timing difference between an unregistered Eurodollar offering and a registered U.S. offering. We can do a Eurodollar offering today in forty-eight hours and, practically speaking, we can do an S-16 in forty-eight hours. The timing using Form S-16 is not significantly different from that of a fast-track Eurodollar offering. We have, or should have, outgrown the old bug-aboo that the Eurodollar offering was fast and quick, involving no long hassle with the SEC or those horrible things called the registration and comment processes. Today, in terms of timing and mechanics, the SEC registration process is the equal of the Eurodollar process in terms of speed and flexibility in coming to market.

MR. HAWES: For the large companies, the same companies that would be issuing . . . .

MR. NATHAN: The realistic issuers in Europe, the people whom the European investment community will accept, are by and large S-16 issuers. There is a small irony here: a company like Ford is not an S-16 issuer this year, because in 1980 it lost money. That is going to be a problem for one year--if Ford makes money this year. Except for the irony that some of the largest U.S. companies cannot use S-16 because of a loss year, there are more S-16 companies than are likely to be saleable in Europe--at least at present.

There is a great deal of congruity. One can think in terms of registering a world class offering of securities with the SEC. Let us forget about lock-up mechanics; why worry about them? They are a nuisance. Register on Form S-16. If the issuer or underwriters want to design a security that is designated for, or designed to appeal to, the Eurodollar market, go ahead and do it. If there are Americans who are benighted enough to want that security, let them buy it. In the equity area, where the design on the security is probably much less significant and there is much less variation in terms of the markets, this seems to me clearly the right way to go. I am somewhat surprised that registration of Euro-offerings on Form S-16 has not started to happen. At least, it has not in my experience.

I suspect part of the problem is that the pressures of getting to market are so large today. Investment bankers and attorneys just do not have time to step back and ask, why are we following the

classic pattern we are following? If the client calls up and says, "We are doing a Eurodollar issue in forty-eight hours," you get out the Eurodollar papers and mark them up. You never stop to think, is there another way to skin this cat? But it is time that we begin thinking about new approaches, and I believe in the long run many artificial distinctions between a Eurodollar security and an American security will break down. The market will demand what it demands with regard to terms: interest rates, maturities, bearer versus registered bonds. That is fine, and you can design a security directed to a specific market. But let us stop worrying about registration versus lack of registration and lock-ups for the U.S. companies.

### 3. FOREIGN ISSUERS IN THE U.S. MARKETS

The much harder problem appears when we turn to foreign companies. The typical foreign company was for many years virtually oblivious to the problems of the 1933 Act and Release 4708. (This, of course, is a crude generalization.) Although it is not true of every Eurodollar offering, over the years there have been a great number of offerings denominated in dollars by European issuers that, in effect, ignored the 1933 Act and Release 4708. This pattern, however, has begun to change; and I think the market and the documentation are reflecting the change. More and more European issuers are becoming known to the U.S. investing community. (I want to come back to that in the context of the secondary markets.) A number of them have done Yankee bond issues--not a great many, but there have been a number of Yankee bond issues by private companies. Commercial paper programs are expanding on behalf of European issuers. The American market is waking up to the attractiveness of the European issuers, on both the equity and the debt sides.

#### A. Flow-back

As this happens, the potential for the European-issued security to flow into the U.S. becomes more and more real. The distinction between the U.S. issuer and the foreign issuer, in terms of likelihood of the security trading in the U.S., begins to break down. The result has been a somewhat confused set of patterns that are being adopted by European issuers in their Euro-security issues. Some European issuers make what one might call a minimal attempt at satisfying Release 4708 by merely stating that the securities are not to be sold in the U.S. A somewhat more cautious approach is to have contractual promises on the part of the underwriting group not to sell in the U.S., but without any lock-up procedure. Other European or non-U.S. issuers--the Canadians also play a great role in this--have gone to the full ninety day lock-up procedure.

There are any number of patterns, and the rhyme and reason for them are difficult to discern. As a practical matter, the approach to the 1933 Act and Release 4708 depends largely on the sophistication and attitude of a small group of people, usually the lawyers who--often under great time pressure--make the decision as to appropriate compliance.

Many of the U.S. lawyers working in this area are aware of and are trying to come to grips with the problem, but their European and English colleagues may not be as aware. There is also the difficulty of reaching a consensus and ultimately of answering

correctly the fundamental question--what is "reasonably designed to prevent an illegal distribution"--when you are dealing with a myriad of foreign companies and entities issuing very different kinds of paper, ranging from twenty or twenty-five year straight debt instruments to very, very short-term floating-rate notes. A solution that may be reasonable in one circumstance may be unreasonable in another. There is also the problem of the so-called "tap" issues, which are, in effect, repeat issues or a continuous issue. How do you deal with that type of offering under the 1933 Act? How do you deal with the floating-rate instruments? How do you deal with short-term paper? These have created serious problems for the lawyers, and they are struggling for solutions.

## B. Disclosure

MR. FRIEDMAN: Chuck, are you in accord with the general approach that the Commission has taken to the problems--the whole notion of the applicability of a lock-up and of the ADR [American Depository Receipts] procedure? Does all that make sense to you, or do you think we ought to be doing something different?

MR. NATHAN: Yours is a hard question, Steve. The ADR issue, I think, presents highly specialized problems that are somewhat different.

MR. FRIEDMAN: Well, they are really concerned with what disclosure obligations arise when those securities end up in our markets. The essence of integration is to erase the difference between the disclosure obligations arising from a distribution and from secondary trading in the market. So in some sense, it is really the same issue.

MR. NATHAN: The problem is, given the variety of factual patterns, can we try to conceive of a simple set of rules to deal with them? I am very skeptical. I am afraid that if we try to set up a simple set of rules they will turn out to be onerous rules. We will start out with the idea that we cannot take any chances; therefore, maybe ninety days is not enough. If the SEC were forced or chose to make pronouncements in this area in a more formal way . . . .

MR. FRIEDMAN: I am really suggesting that the whole notion of a lock-up--ninety days or a thousand days--may be misguided, because the essential question is the nature of the information available in our markets when securities are traded here. That is the underlying policy issue.

### (i) 20-F registration

MR. NATHAN: That is right. That is the bottom line, Steve. But how do you come to grips with that issue through Form 20-F, for example? I think we are all prepared to accept the idea of using integration, as Bob Pozen was suggesting. The problem is 20-F. How many foreign issuers are now reporting on 20-F? The last time I looked, it was something like twenty-eight. There are not many companies out there prepared to go through the 20-F disclosure process. They are no more prepared to go through the 20-F disclosure process than they were prepared to go through the historical S-1 disclosure process. Until we can solve that problem, I do not think we can solve the flow-back problem and the secondary market problem.

MR. POZEN: Form 20-F is for companies that are listed on exchanges. Foreign issuers are not listed on exchanges in most cases unless they are making a primary offering in the U.S. It might have been more logical for the SEC to start off by reforming the 1933 Act forms and then to work with the 1934 Act forms. Once the SEC decides on the modifications for 1933 Act forms for foreign issuers, we will see more issuers using Form 20-F.

(ii) *Viewpoint of foreign issuers*

MR. NATHAN: I am very dubious about that, Bob. I have counselled a number of foreign issuers considering a public offering in the U.S. The fundamental disclosure problems are there. Form 20-F is perhaps better than Form S-1, but it is not much better. Foreign issuers are still very, very averse to disclosure. Frankly, they are concerned that they will be caught up in a disclosure system over which they have no control. If they look at what has happened to the SEC reporting system over the last fifteen or twenty years, the pattern for domestic issuers is one of increased disclosure, increased disclosure, increased disclosure. I cannot promise a foreign issuer that this pattern of increased disclosure is not going to continue in the future or that it will not apply to foreign issuers.

I do not suggest that this is the wrong pattern. Looking at it as a domestic lawyer worrying about U.S. companies, I have always been very sympathetic with the full disclosure pattern. I think the new management analysis is a welcome step. It is very interesting but difficult to deal with. When you show it to a foreign issuer, that ends the discussion. The typical foreign issuer does not want to hear anything more about it; all it cares about is staying away from the SEC and the SEC's disclosure system. I agree with Michael Coles' remarks this morning: somewhere there is a line one can draw on a cost/benefit basis. The question is difficult. When is the level of pain to the foreign issuer sufficiently reduced to entice him into our markets, and what can or should we offer him?

MR. HAWES: Do you have the same catalogue of concerns that Michael had? The segment reporting, the executive compensation, and so on? Or it is just that there is too much information required?

MR. NATHAN: Well, that is the catalogue that you tend to run up against time after time after time.

MR. POZEN: When dealing with foreign issuers, you often have a vague and general feeling that there is a problem in coming to the SEC. If you ask the issuers to be specific, they usually object to segment reporting, and management remuneration, and that sort of thing. But if you say to them then, "Well, look what has happened in 20-F. Could you live with that?" Most of the ones I have talked to say, "I could live with that and I am sort of interested." You are suggesting that even if the SEC took all the 20-F accommodations and put them into the 1933 Act forms, there would still be specific disclosure problems that foreign issuers would have, over and above the general thought that the SEC could come after them. What specific other problems do you see?

MR. NATHAN: I think it is clearly true that 20-F is better than S-1 right now, and that is a help. But the accounting area is a very, very difficult problem, and the auditing area . . . .



MR. POZEN: Wait a second . . . the accounting area? The SEC in 20-F said you could use your own, non-GAAP standards; you just have to explain the material differences. I think that is all anybody can hope for.

MR. HAWES: And Roy Herbert says that for the three hundred biggest companies those standards are not all that different.

MR. NATHAN: But there is a tremendous problem with auditing standards in a lot of countries.

MR. POZEN: Auditing standards? Roy would say that most of the issuers that are seriously thinking of coming into the U.S. are probably using Big Eight accounting firms or Big Eight affiliates.

MR. NATHAN: Generalizations are difficult. There is no question but that we can go too far in any of these ways. Form 20-F is voluntary. Nobody has to list. Everybody who has listed--with a few historical accidents--has done so on the basis of a voluntary decision and their own cost/benefit ideas. To say, "We will make it a little bit easier," means a few more people will make the voluntary decision. I am not suggesting it is a desirable thing to rush to woo foreign issuers. My point was that until we solved the fundamental problem of 1933 Act registration and 1934 Act reporting in a way acceptable to foreign companies, we are not going to be able to solve the flow-back problem involving their securities through some simplified registration form like S-16. Foreign companies are not going to register under the 1933 Act just to avoid ninety day lock-ups.

*(iii) Psychological barriers*

MR. FRIEDMAN: I think what Bob was suggesting is what I was groping toward earlier. The fact that a small number of companies have chosen to register suggests that this is really not a minor problem. What is involved is a much deeper suspicion about getting involved with the Commission and the disclosure system--fear of future changes, of the enforcement program, of the Foreign Corrupt Practices Act, and of the whole panoply of corporate governance issues.

MR. NATHAN: I think that is right, Steve. It is a psychological barrier, much of which is based on fear of the unknown. The amount of misinformation that foreign issuers have about what the process entails and how painful it is, is astounding. They also have misinformation about our antitrust enforcement policies. I have talked to a large number of foreign issuers who are convinced the antitrust agencies are a political tool designed to punish foreign companies so that American companies can prosper. This view is very far from the truth, but somehow a number of foreign companies have managed to persuade themselves. There is a tremendous amount of psychological resistance to U.S. legal concepts, and it is not just in the securities area.

#### 4. SECONDARY MARKET TRADING IN FOREIGN SECURITIES

I now would like to address the question of secondary market trading in the U.S. of foreign issued securities. As Steve said earlier, the current movement in the U.S. is to avoid artificial distinctions between primary offerings and secondary offerings. But we do have a secondary market--a very large and liquid secondary market--in the U.S. What is the role of foreign securities in that market? I have time only to make a few observations.

Broker-dealers and investment bankers tell me that today a number of major firms are making concerted marketing efforts among their U.S. institutional customers to sell them on the merits of investing in foreign securities. They do it on the debt side on the basis of yield curves and yield spreads and similar differentials. Their pitch is to convince the U.S. institution that investing in a foreign security is just money in the pocket, very often from the same issuer. If you can buy a Ford Motor bond that yields twelve percent here, and a similar Ford Motor Eurodollar bond is yielding fourteen percent in Europe, you know which one you should buy. On the equity side, there is a similar effort to introduce Americans to foreign equity issues. A number of firms are trying to market foreign equities and foreign debt instruments to their customers in the U.S., and they are creating more analytical tools to aid their efforts. Analysts are following more foreign companies. They are doing studies of sovereign risk on a country by country and area by area basis. They are trying to educate their customers.

##### A. Effects of the 1933 Act

The U.S. securities laws are not the only hindrance to this effort to increase investment in foreign securities. Legal investment laws and tax laws cause difficulties too. But one of the fundamental problems is the 1933 Act because--going back to the starting point of this discussion--the 1933 Act is structured to bar offers and sales of securities using interstate commerce unless there has been a registration statement or there is an exemption from registration.

The exemption that permits the U.S. domestic secondary market to operate is the so-called dealer's exemption in section 4(3). It has a number of clauses and is a very difficult statutory provision to work with. One of the clauses of section 4(3) states that forty days after a bona fide public offering any dealer can trade a security. That is a clear exemption; the dealer is free to do it. If you were to consider only this exemption, you might wonder why we have developed such elaborate procedures for Euro-securities, including ninety day lock-ups, and instead assume that forty days after the public offering in Europe anyone would be free to bring the Euro-securities into the U.S.

There are two major caveats to that forty day exemption that explain why life cannot be so simple. One is that the forty day exemption is not applicable to an underwriter. Second, it is not applicable with respect to a dealer's allotment in an underwriting. This brings us to the fundamental question of direct or indirect participation in the distribution. Stated most simply, the forty day exemption is not available if the broker-dealer is directly or indirectly participating in the distribution. In other words, the exemption operates safely only when a dealer purchases securities

from the ultimate investor after they have come to rest in his hands and after the distribution is complete.

How does a broker-dealer know what kinds of securities he is being offered in Europe to re-sell in the U.S. and who they are from? Historically, the SEC has demanded that the broker-dealer community police the market in the U.S. with respect to foreign-issued securities as well as domestic issues. A broker-dealer's policing obligation is hard to find written in the law as such. But, as a practical matter, the brokerage community in the U.S. must police its trading activities in foreign securities and cannot afford to get caught bringing foreign securities to the U.S. as part of the original offering. Any repeated pattern of doing this, and you know that Stanley Sporkin will appear on your doorstep.

## B. The Seasoning Rule

The result of the need by brokers for self-policing has been another one of these ad hoc sets of rules--usually called the seasoning rule. Every brokerage firm has its own seasoning rule, and the seasoning rules are different. Broker A says, "I am going to be very safe. I will not trade a foreign security until at least a year after it was originally issued because I do not trust the European distribution practices. It is not worth my bother to have the SEC on my back. I am not going to touch any European issued security until a year after the initial distribution, and even then I am going to be aware of the circumstances. If there are suspicious circumstances, I will make inquiry." Broker-dealer B says, "A year is too long. I will take six months." Broker C is in between and says, "Nine months," and it can point to an analogy in another SEC rule.

There is, of course, at least one problem: a problem of different rules. There is no uniformity, and there is always the risk of a race to the bottom--each time a broker ratchets down its seasoning period by a week or a month, its competitors may ratchet down their seasoning period too because they do not want to be left behind.

Here is an area where it seems to me that effective SEC rule making is possible, although not easy. There was once an attempt to persuade the SEC to adopt a ninety day presumptive seasoning rule. That was in 1974, I believe. It went nowhere. I do not know whether it failed because of the concern that the proposed ninety day seasoning period was not long enough or it failed because the SEC was not willing to get involved in what conceptually may be a factual morass.

If you consider the underlying principles, you find yourself in an area where the facts count. The crucial fact to be determined is whether or not the securities in question are part of a distribution. Passage of time can be only presumptive, and it may be that the SEC felt it was not prepared to have an absolute time rule that would prevail over the true facts of the case. Nevertheless, there is a barrier to bringing European securities into the U.S. secondary market--the informal seasoning rules designed to ensure the availability of the dealer's exemption under the 1933 Act for secondary market trading.

## NOTES

[1] Securities Exchange Act Release No. 4708, 29 Fed. Reg. 9828 (1964).

## APPENDIX XV

OUTLINE OF RULES APPLICABLE  
TO FOREIGN MARKET TRADING AND EURO-SECURITIES

by Charles M. Nathan and Robert P. Davis

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## A. Secondary Trading in the United States of Unregistered Securities Issued Abroad

### 1. Introduction: The Euro-security Market

The registration requirements of the Securities Act of 1933, as amended (the "1933 Act"), apply to the offer or sale of any security involving the use of interstate commerce or the mails unless an exemption is available. Section 2(7) of the 1933 Act defines "interstate commerce" to include "trade or commerce in securities or any transportation or communication relating thereto . . . between any foreign country and any State, Territory, or the District of Columbia." Accordingly, the 1933 Act would appear to require U.S. corporations to register all offerings of securities abroad even if limited to non-U.S. nationals or residents. Moreover, offerings by either U.S. or foreign corporations abroad to U.S. nationals or residents (directly, or indirectly through dealers, individuals, or institutions performing the customary role of dealers) would appear to require 1933 Act registration if any jurisdictional means have been utilized.

a) *Release 4708*. In Release No. 33-4708, July 9, 1964 (Release 4708), however, the SEC indicated it would not recommend enforcement action under Section 5 of the 1933 Act if U.S. corporations failed to register offerings of securities abroad to foreign nationals, notwithstanding that the offering originated in the U.S., that domestic broker-dealers were involved, or that the mechanics of distribution were effected in the U.S., provided that the offers were made under circumstances "reasonably designed to preclude distribution or redistribution of the securities within, or to nationals of, the United States." The SEC noted, however, that distributions of securities by U.S. corporations in Canada through the facilities of Canadian stock exchanges "may be expected to flow into the hands of American investors and may therefore be subject to registration." U.S. corporations have issued securities in the Euro-security market to non-U.S. nationals or residents in reliance on Release 4708 by utilizing procedures intended to assure that the securities "come to rest" abroad—i.e., that the entire distribution process results in the securities being held by or for the benefit of non-U.S. investors, as opposed to intermediaries in the distribution chain who are holding for resale to U.S. investors. These procedures have been strengthened since 1974, when the Interest Equalization Tax was allowed to expire, thus eliminating a major economic impediment to the purchase by U.S. residents and nationals of unregistered securities issued abroad.

b) *The 90-Day Lock-Up of Debt Issues*. With respect to the distribution abroad by U.S. corporations of debt securities denominated in U.S. dollars, the following procedures are generally followed:

(1) Contractual restrictions contained in underwriting documents prohibit participants in the distribution from offering or selling the securities constituting their allotment in the U.S. or to nationals or residents of the U.S. until ninety days after the distribution abroad has been completed, as determined by the manager.

(2) Participating underwriters further agree that they will not, as principal or agent, make any offers or sales of any of the Euro-securities (not just their allotments) in the U.S. or to U.S. nationals or residents until ninety days after the completion of the distribution, as determined by the manager.

(3) Each underwriter and selling group member agrees to deliver a written confirmation to each purchaser of securities from it. With respect to retail purchasers, the confirmation states that such purchaser agrees not to offer or sell the securities in the U.S. or to U.S. nationals or residents prior to ninety days after completion of the distribution. If the purchaser is a dealer, the confirmation states that the dealer has not and will not offer or sell the se-

curities in the U.S. or to U.S. nationals or residents, that such dealer is not purchasing the securities for the account of any U.S. national or resident, and that such dealer will include similar statements on written confirmations delivered to purchasers of the securities from it.

(4) Each underwriter and member in the selling group is required to confirm by telex to the managing underwriter that its allotment has been sold outside the U.S. to non-U.S. residents or nationals.

(5) Individual temporary certificates are originally issued for the distributed securities, without interest coupons or conversion privileges, as the case may be. The temporary certificates are not exchangeable for permanent certificates until ninety days after the managing underwriter has advised the participants, on the basis of "all-sold" telexes and other factors, that the distribution has been completed abroad. Furthermore, such permanent certificates are issuable only upon receipt of a certification from the beneficial owner that such owner is not a national or resident of the U.S. An important variation on this procedure is the initial issuance of a single non-interest bearing global bond, representing the entire issue, which is deposited with a clearing system and which is exchangeable at a later date for definitive bond certificates.

These ninety day lock-up procedures have been approved in no-action letters issued by the SEC staff. See, e.g., *Fairchild Camera and Instrument International Finance N.V.* (avail. December 15, 1976); *Raymond International Inc.* (avail. June 28, 1976); *The Singer Company* (avail. September 3, 1974); *Pacific Lighting Corp.* (avail. June 13, 1974). As far as we are aware, however, the use of a global bond certificate deposited with a foreign clearing system has not yet been directly approved by the SEC staff in a no-action letter.

Whether non-U.S. dollar denominated obligations of U.S. issuers should be issued in the Euro-security market subject to all of the elaborate safeguards described above with respect to U.S. dollar denominated issues is less clear. For a description of one variation on these lock-up procedures approved by the SEC staff in connection with an issue of yen-denominated bonds primarily in Japan by a wholly-owned financing subsidiary of Sears Roebuck & Co., see *Sears Overseas Finance, N.V.* (avail. April 13, 1979).

The ninety day lock-up period referred to above was apparently derived by analogy to Section 4(3) of the 1933 Act (the "dealer's exemption"). Section 4(3) exempts from the registration and prospectus delivery requirements of Section 5 of the 1933 Act:

transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except --

(A) transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through the underwriter,

(B) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 8 is in effect as to the security), or

such shorter period as the Commission may specify by rules and regulations or order, and

(C) transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter.

With respect to transactions referred to in clause (B), if securities of the issuer have not previously been sold pursuant to an earlier effective registration statement the applicable period, instead of forty days, shall be ninety days, or such shorter period as the Commission may specify by rules and regulations or order.

Although the forty day period prescribed by paragraph (A) of Section 4(3) would appear to be more relevant to the offering of *unregistered* securities that had been sold outside the U.S. to non-U.S. investors, the no-action letters referred to above appear to have fixed upon a ninety day period by analogy to paragraph (B) of Section 4(3).

In certain circumstances, however, it may be advisable for U.S. issuers to extend the lock-up procedures for more than ninety days. For example, in connection with an issue of units, consisting of Series A bonds and warrants to purchase Series B bonds, where the warrants are not exercisable for six months, a U.S. issuer probably should view the offering of Series A bonds, warrants and Series B bonds as one distribution, and therefore probably should choose a longer lock-up period of, perhaps, nine months in order to make sure that all of the offered securities come to rest abroad.

c) *Equity Issues*. Because offerings abroad to non-U.S. nationals or residents of equity securities of U.S. companies appear to present a greater risk of flow-back to the U.S. market, the SEC has granted no-action letters in these circumstances only where transfer of the equity securities was prohibited absolutely for ninety days after the completion of the distribution abroad and transfers were permitted after the ninety day period only if, in the opinion of counsel, such transfers would be in compliance with the registration requirements of the 1933 Act or an exemption therefrom. Certificates representing such shares are usually legended and appropriate stop transfer instructions are usually given to the transfer agent. See e.g., *American Eastern Real Estate and Investment Corporation* (avail. November 27, 1978); *Foote, Cone & Belding Communications, Inc.* (avail. June 21, 1976).

d) *Partnership Interests*. A series of recent no-action letters have approved the sale outside the U.S. to non-U.S. nationals or residents of limited partnership interests in limited partnerships organized in the U.S. without compliance with the registration requirements of the 1933 Act. In order to restrict the flow-back of such limited partnership interests to the U.S. and, in several of the offerings, Canada as well, the limited partnership agreements provided that (i) all transfers of limited partnership interests must be approved by the general partners, (ii) no such transfers may be made to U.S. (or Canadian) nationals or residents within twelve months after completion of the distribution, and (iii) notwithstanding the expiration of such twelve month period, no transfers may be made to U.S. (or Canadian) nationals and residents unless such limited partnership interests are registered under the 1933 Act or an opinion of counsel has been delivered to the general partners that such transfers are exempt from registration. In addition, underwriters and service agents in the offering must agree not to offer or sell the limited partnership interests in the U.S. (or Canada) or to nationals or residents of the U.S. (or

Canada). See *Pembroke Pines Plaza Associates, Ltd.* (avail. September 22, 1980); *Forest Oil Corp.* (avail. August 11, 1980); *ONEC Exploration, Ltd.* (avail. June 23, 1980). See also *Spirit Mountain Farms West* (avail. February 6, 1978). In *Sanchez-O'Brien Oil & Gas Corp.* (avail. June 23, 1980) the SEC staff granted a no-action letter with respect to an unregistered foreign offering of general partnership interests in a domestic general partnership, limited partnership interests in a German limited partnership and shares of a Netherlands Antilles corporation, where three of the general partners of the domestic general partnership would be a U.S. corporation, the German limited partnership, and the Netherlands Antilles corporation.

e) *Non-U.S. Issuers.* Although Release 4708 was directed exclusively to offerings abroad by U.S. issuers, it should follow a *fortiori* that the registration requirements of the 1933 Act have no greater application to offerings abroad by foreign issuers. Indeed, whether any restrictions are needed, and, if so, what type of restrictions are needed, to prevent distributions in the U.S. or to U.S. investors of unregistered foreign securities offered abroad would appear to depend on the attractiveness of the securities to U.S. investors. The more attractive a foreign issue to U.S. investors, the more prudent it would be for the foreign issuer to utilize more elaborate procedures designed to assure that the securities come to rest abroad.

(1) The attractiveness of a foreign offering to U.S. investors may depend on a variety of factors. A market in the U.S. is perhaps more likely to exist for Canadian issuers than other foreign issuers. Demand for securities of foreign issuers is also likely to exist in the U.S. if a market already exists in the U.S. for other securities of the same issuer. Thus it is generally thought that issuers of Yankee bonds have a heavier obligation to take steps to prevent their Eurobonds from coming into the hands of U.S. purchasers than is the case for issuers that have not come into the U.S. market. Whether the same considerations apply to issuers that have sold only commercial paper in the U.S. is considerably less clear, but practice to date seems to be to attach less weight to commercial paper issuance. Securities of foreign issuers that conduct substantial activities in the U.S. may also be more likely to be attractive to U.S. investors. Traditionally, it has been thought that the same was true of dollar-denominated or dollar option bonds, but with increasing sophistication of investors and widespread activities in currency hedging, it may be questioned whether this rationale continues to be persuasive. The attractiveness of the foreign issue to U.S. investors may also be increased if the managing underwriters are affiliated companies of U.S. securities firms or banks or non-U.S. banks or securities firms that conduct substantial activities in the U.S.

(2) As a practical matter, a variety of approaches has been taken by foreign issuers in connection with offerings of unregistered Euro-securities. Certain of these approaches, while less restrictive than the ninety day lock-up procedures, may nevertheless be "reasonably designed to prevent distribution or redistribution of the securities within, or to nationals of, the United States," assuming accurate assessments of the circumstances involving the offerings have been made. In circumstances in which a significant risk of flow-back to the U.S. market exists, however, foreign issuers would be well advised to utilize the ninety day lock-up procedures sanctioned by the SEC staff in its no-action letters with respect to U.S. dollar denominated Euro-securities of U.S. issuers.

(3) Even in offerings of U.S. dollar obligations, many foreign issuers have not found it necessary to utilize the ninety day lock-up procedures. Instead, these foreign issuers have found it prudent simply to rely on contractual restrictions contained in the underwriting documents designed to preclude distribution of the securities in the U.S. or to U.S. investors. Under this contractual restriction approach, the underwriting papers impose on the underwriters, selling group members, and dealers involved in the distribution, the obligation



to refrain from offering or selling the securities in the U.S. or to U.S. investors as part of the distribution. In addition, the prospectus indicates that the securities are not registered under the 1933 Act and are not being offered or sold in the U.S. or to U.S. investors. Depending upon the circumstances, it may also be possible for U.S. issuers of non-U.S. dollar denominated obligations in the Euro-security market to rely on this contractual restriction approach.

(4) With respect to the offering by foreign issuers of Euro-securities denominated in currencies other than the U.S. dollar, the underwriting papers may often contain no reference to the U.S. securities laws at all, although these documents would usually prohibit offers or sales of the securities in violation of any applicable law.

(5) Nevertheless, as indicated above, certain foreign issuers have chosen to utilize the ninety day lock-up procedure, while others have chosen to use a completely different approach that incorporates all the elements of the contractual restriction approach, but also includes specific restrictions on secondary market transactions by underwriters and dealers in the U.S. or with U.S. investors for a period, usually of nine months, following the date of the closing. Because the U.S. is a natural market for Canadian borrowers, Canadian issuers of U.S. dollar Euro-securities should generally consider using the ninety day lock-up procedures. The ninety day lock-up procedures may also be the prudent approach for other foreign issuers of U.S. dollar Euro-securities, especially if an established public market for other securities of the issuer exists in the U.S. (as would be the case if the issuer has issued or guaranteed Yankee bonds in the U.S., or if the issuer's equity securities are traded on a U.S. stock exchange or in the U.S. over-the-counter market). Other special circumstances may also indicate that the ninety day lock-up procedures should be utilized by foreign issuers.

f) *Floating Rate Issues.* As a matter of practice, one type of foreign security that is typically issued in the Euro-security market subject to modified ninety day lock-up procedures are notes or bonds issued with interest rates that are adjusted periodically based upon the London interbank rate--so-called floating rate securities. Underwriting agreements usually permit offers and sales of these securities to branches of U.S. banks located outside the U.S. provided that the branch represents that it is acquiring the securities for its own account and not with a view to distribution and agrees that if it should dispose of the securities in the future, it will not offer or sell such securities directly or indirectly in the U.S. or to U.S. nationals or residents, except that, with the prior approval of the managers, it may offer or sell such securities to a branch of a U.S. bank located outside the U.S. provided that the purchasing bank agrees to similar limits on offers and resales. Unlike fixed-rate notes issued in the Euro-security market, floating rate Euro-securities usually bear a 1933 Act legend. In no-action letters, the SEC staff has indicated that in special situations debt securities may be offered and sold abroad without registration to foreign branches of U.S. insurance companies and banks that would technically be regarded as U.S. nationals as long as it is reasonably clear that the securities will come to rest abroad. The significant factors the SEC staff appears to emphasize in these circumstances are (i) denomination of the debt securities in a non-U.S. dollar currency, (ii) absence of a market in the U.S. for the securities and (iii) the probability that the foreign branch purchaser will hold the securities to maturity. See, e.g., *Dresser Industries Canada, Ltd.* (avail. October 31, 1977); *Ford Motor Credit Co.* (avail. July 16, 1975),

g) *Registering Flow-back on Form S-16.* In order to avoid utilizing the complex lock-up procedures described above, some qualified issuers have chosen instead to register on SEC Form S-16 the potential flow-back of an offering made outside the U.S. to non-U.S. investors. See *Farinon Electric* (avail. September

27, 1976). This method is often used by Canadian issuers in connection with Canadian offerings where securities of the same class are already registered with the SEC and traded in the U.S. See Bell Canada, Amendment No. 1 to Registration Statement on Form S-16, Registration No. 2-63390 (filed February 13, 1979). The SEC staff apparently has allowed companies to register less than the entire amount of a foreign offering as long as the amount reasonably expected to be resold in the U.S., plus an additional cushion of 10-15 percent of the offering, have been registered. In addition, the SEC staff has permitted registrants to insert a legend in foreign prospectuses referring to the availability of the S-16 and the documents incorporated therein by reference, rather than requiring registrants to deliver the S-16 prospectus abroad. See also Release No. 33-6240 (September 10, 1980) (certain foreign governments and political subdivisions thereof are permitted to file annual shelf registration statements on Schedule B with respect to offerings in the U.S. and potential resales of offerings initially made outside the U.S.); *Kingdom of Sweden* (avail. September 22, 1980).

h) *Simultaneous Private Placements*. It is possible that unregistered securities may be sold in the U.S. during a foreign distribution of such securities in reliance on the so-called private placement exemption contained in Section 4(2) of the 1933 Act. Section 4(2) of the 1933 Act exempts from the registration requirements of the 1933 Act "transactions by an issuer not involving any public offering."

(1) Release 4708 indicates that the SEC will not integrate (that is, consider as a single overall transaction) valid private placements of securities in the U.S. with simultaneous public offerings abroad, thereby subjecting such private placements to the registration and prospectus delivery requirements of the 1933 Act.

(2) In cases where a ninety day lock-up is deemed advisable, such simultaneous private placements will ordinarily be prohibited by the terms of the underwriting or selling group agreement governing the offering of such securities abroad. As noted above, such agreements typically preclude participants in the distribution from making any sales of securities to U.S. investors until ninety days after the offering has been completed abroad and require beneficial owners of the securities to represent, as of the date the temporary global bond or note is exchanged for definitive certificates, that they are not nationals or residents of the U.S.

i) *References*: See Pergam, *Eurocurrency Financing: Securities Law Considerations for U.S. Corporate Issuers* in Fordham Corporate Law Institute, *Financing in the International Capital Market*, at 241-93 (1980) [hereinafter *Fordham Institute*]; Spencer, *Moving with the Flow: World Capital Formation and the United States Securities Laws*, in *Fordham Institute* at 76-80.

## 2. Trading Unregistered Euro-securities in the U.S. Market

How soon after the commencement of an unregistered offering of U.S. or foreign securities outside the U.S. to non-U.S. nationals or residents may broker-dealers commence trading such securities in the U.S.? As described above, the registration provisions of the 1933 Act prohibit any offers or sales of securities when jurisdictional means are utilized unless a registration statement is in effect with respect to such securities or an exemption from registration exists. By its terms, therefore, the 1933 Act applies both to primary and secondary offerings of securities.

### a) *Dealer's Exemption*

(1) One exemption from registration that may be relied on by broker-

dealers to commence trading in the U.S. in unregistered securities issued abroad is Section 4(3) of the 1933 Act--the so-called dealer's exemption. It would appear from a literal reading of Section 4(3)(A) of the 1933 Act (set forth above in paragraph A.1.b.) that the earliest time a dealer that is not a statutory underwriter should be able to trade in the U.S. in unregistered securities issued abroad would be forty (or perhaps ninety) days after such securities were first offered to the public abroad, provided that such securities are not part of such dealer's unsold allotment. Although this section appears to be the basis upon which the ninety day lock-up procedures described above were derived, the ninety day lock-up procedures for debt offerings, unlike the dealer's exemption, measure the ninety day period from the time the managing underwriter determines that the distribution has been completed abroad, rather than first offered abroad.

(2) One case, however, appears to indicate that the dealer's exemption should not apply until after the securities had first been illegally offered to the public in the U.S. See *SEC v. North American Research & Dev. Corp.*, 280 F. Supp. 106, 125 (S.D.N.Y. 1968), *aff'd in part, vacated in part*, 424 F.2d 63, 81 n.14 (2d Cir. 1970). Moreover, the legislative history can be read to support this interpretation that Section 4(3)(A) applies only to unlawful distributions of securities as to which registration statements should have been filed, in contrast to unregistered distributions of securities as to which the registration requirements of the 1933 Act did not apply. See Sen. Rep. No. 1036 at 14, H. Rep. No. 1542 at 22, 83rd Cong., 2d Sess. (1954); SEC Release No. 33-4726 n.3 (1964). Under this interpretation of Section 4(3)(A), the forty (or ninety) day period would not begin to run with respect to securities lawfully offered to non-U.S. residents or nationals abroad without registration under the 1933 Act until such securities were first illegally introduced into the U.S. market. See also *Legal Problems of Issuing and Marketing Foreign Securities in the United States*, in *International Financing and Investment at 450-51* (McDaniels ed. 1964); Cohen & Throop, *Investment of Private Capital in Foreign Securities*, in *Lawyer's Guide to International Business Transactions at 585-86* (Surrey & Shaw eds. 1963).

(3) Notwithstanding the authorities referred to above, the restrictive reading of Section 4(3)(A) cannot be correct. It makes no sense to afford more favorable treatment to unregistered securities illegally offered in the U.S. than to unregistered securities legally offered abroad to non-U.S. residents or nationals. As a matter of policy, the dealer's exemption must be available at some point to permit secondary trading in securities issued in lawful, exempt transactions. In fact, absent the applicability of the dealer's exemption to legally offered unregistered securities, dealers would be unable to deposit foreign securities in return for American Depository Receipts (ADRs) unless in every case the underlying securities deposited had been registered under the 1933 Act. The fact that issuers offering securities abroad, which are traded in the U.S. in the form of ADRs, often choose to register with the SEC only a portion of the offering (a practice long sanctioned by the SEC staff) lends further support to the argument that the dealer's exemption should not be given such a restrictive reading. Under these circumstances, dealers would be acting at risk when trading in the securities in the U.S. at a time when they were prohibited from trading in the unregistered portion of the offering because they would be unable to distinguish the registered portion of the offering from the unregistered portion. This would not make sense because at that time a registration statement with respect to the securities would have been filed with the SEC and prospectuses disseminated in the U.S., thus satisfying the 1933 Act's disclosure policies.

b) *The SIA Proposal*. In 1974, the Securities Industry Association had proposed that the SEC issue a release to create a presumption, with respect to underwritten distributions abroad of straight debt obligations of foreign issuers, that a U.S. broker-dealer would be participating in an illegal distribution within

the U.S. if it sold the security in the U.S. or to a U.S. national or resident within ninety days after the initial offering of such securities abroad. See Williams, *Trading in the United States in Foreign Securities Distributed Outside the United States Without Registration Under the Securities Act of 1933*, in Sixth Annual Institute on Securities Regulation (PLI) 327, 348-49 (1975). Although the SEC declined to accept the SIA's proposal as presented, the SEC subsequently considered adopting an objective test to replace the imprecise and vague coming to rest doctrine. See "Is the SEC a Barrier to New York's Role in International Finance?" Address by SEC Chairman Garrett, in *Securities Regulation & Law Rptr.* (BNA), No. 257, at D-1 (June 19, 1974); letter of Carl T. Bodolus, Chief, Office of International Corporate Finance, to Michael H. Coles, Chairman, International Finance Committee at the SIA, dated February 26, 1976. See also *Cardiodynamics, Inc.* (avail. July 5, 1974). This effort to create objective guidelines appears, however, to have been abandoned.

### c) Seasoning Period

(1) Although the ninety day lock-up procedures appear to be sufficient to convince the SEC staff not to take enforcement against an issuer or underwriting group in connection with unregistered offerings abroad of securities to non-U.S. investors, the SEC staff has not conceded that unregistered securities issued abroad may be resold in the U.S. without violating the 1933 Act after the expiration of the ninety day lock-up period. Moreover, because of the uncertainties that exist with respect to the applicability of the dealer's exemption to the secondary trading in the U.S. of unregistered securities that had been issued abroad, and because the dealer's exemption does not come into play if the dealer is deemed to be acting as an underwriter with respect to such securities or as a participant in their distribution, many U.S. broker-dealers have developed internal seasoning guidelines to determine when trading may commence in the U.S. in unregistered foreign securities. These seasoning guidelines are adopted as a matter of prudence and are designed to reduce the risk that when trading such unregistered securities in the U.S. the broker-dealer would be involved in the chain of distribution and therefore would be acting, in effect, as an underwriter or other participant in the distribution because such securities had never in fact come to rest abroad. At least in the case of debt securities, the seasoning period is usually considerably longer than the ninety day lock-up period contractually agreed to by underwriters participating in foreign distributions of U.S. securities in part because of the fear that foreign distribution practices may inadvertently result in a U.S. broker-dealer purchasing unregistered securities that constitute an underwriter's or dealer's unsold allotment.

(2) As a matter of practice, therefore, U.S. brokerage firms generally restrict trading in unregistered debt securities issued abroad for nine months to one year after the completion of the distribution abroad. The nine months to one year seasoning period apparently has been derived by analogy to Rule 147 under the 1933 Act. Rule 147 provides a safe harbor for issuers raising capital from local sources in reliance on the exemption for intrastate offerings provided by Section 3(a)(11) of the 1933 Act. One condition to the applicability of Rule 147 relates to resales of unregistered securities that had originally been offered only to residents of the same state in which the issuer is a resident. Paragraph (e) of Rule 147 prescribes a nine month period from the date of the last sale by the issuer during which resales of such securities may only be made to persons resident within the same state. This nine month rule, therefore, represents the SEC's attempt to define the time period necessary to assure that securities, which had been issued in an exempt intrastate offering, have come to rest.

(3) One way for U.S. broker-dealers to avoid the need to comply with seasoning guidelines would be to place unseasoned Euro-securities with U.S. investors in reliance on the private placement exemption contained in Section 4(2) of the 1933 Act. Such sales would need to be limited to sophisticated U.S. investors

who must represent that they do not intend to distribute the securities to U.S. investors and will not resell in the U.S. or to U.S. investors absent registration or an exemption from the registration requirements of the 1933 Act. With respect to securities of foreign issuers, however, it may be difficult to structure such transactions to conform to traditional private placement standards, if, for example, the purchaser does not have direct access to the issuer or its agent for information and negotiation of terms.

(4) In sum, the problem is that the 1933 Act applies to the distribution of securities to the investing U.S. public, that the dealer's exemption, as a practical matter, is applicable only to secondary trading of securities already distributed (that is, which have come to rest in the hands of the investing public), but that the 1933 Act, the case law, and the SEC offer no objective guidance for determining when a distribution is complete and the securities have come to rest so as to permit secondary trading without violation of the 1933 Act. The adoption by the SEC of rules prescribing objective seasoning criteria could promote uniform treatment by U.S. broker-dealers of the problem of secondary trading in the U.S. of unregistered securities that had been issued abroad and could eliminate the competitive pressures that may now exist among U.S. broker-dealers and may encourage them to cheat on their own self-imposed seasoning rules or to adopt increasingly lenient standards.

d) *Tracing Problems.* The 1933 Act's registration requirements apply only to the specific securities involved in a public offering and not to the entire class of an issuer's securities. See Sen. Rep. No. 1036 at 20-21 and H. Rep. No. 1542 at 29-30, 83rd Cong., 2d Sess. (1954); I L. Loss, *Securities Regulation* 259-60 (1961); IV L. Loss, *Securities Regulation* 2577-78, 2658 (1969). Cf. *Barnes v. Osofsky*, 373 F.2d (2d Cir. 1967). Because the 1933 Act does not employ a fungibility rule (i.e., does not equate already outstanding securities and those subject to a new public offering), a broker-dealer is permitted to continue to trade previously outstanding securities of the class even though the issuer is simultaneously engaged in distributing additional unregistered securities of the same class in the Euro-security market to non-U.S. nationals or residents. As a practical matter, however, at least with respect to straight equity securities such as common stock, the broker-dealer may decide to cease trading all securities of that class in the U.S. because it would be impossible for it to distinguish between the issuer's previously outstanding shares and those issued in the unregistered foreign distribution. The problem, of course, is that equity securities, principally common shares, are often issued as part of an ever-increasing single class and are typically traded on an auction market where the purchaser has no way of knowing the identity of his seller or tracing the origin of the securities purchased. Foreign offerings of debt securities, in contrast, are not usually fungible with other indebtedness issued by the same company (that is, each offering usually constitutes a clearly separate and different class), and the buyer of debt securities almost always would be in a position to know the identity of the seller or the seller's agent. This is not to say, however, that tracing will always be a problem even for common shares. For example, when new shares are not physically issued until a substantial period of time after the initial offering (see, e.g., *The British Petroleum Company, Ltd.* (avail. July 14, 1977)) the newly issued shares (or receipt in lieu thereof) will be readily distinguishable from previously outstanding shares. Similarly, the new shares will be easily distinguishable in cases where the new shares have different initial dividend rights from the previously outstanding shares so that the two kinds of shares would not be fungible in practice for some time after the initial offering. In such circumstances, obviously, no tracing problem exists, and trading should be able to continue in the old shares.

(1) In Release 4708, the SEC indicated that if a distribution of securities by a U.S. corporation is made abroad without registration to non-U.S. investors "dealers may trade in other securities of the same class in the United

States without regard to the time limitation of the dealer's exemption in Section [4(3)]." The SEC did state, however, that if active trading developed in the U.S. in the securities subject to the foreign offering during or shortly after the distribution abroad, the implication may arise that "a portion of the distribution was in fact being made by means of such trading."

(2) If a market in ADRs exists in the U.S., precautions may be taken by the ADR depository to insure that trading in the ADRs simultaneously with a new unregistered distribution of the underlying securities abroad will relate solely to the previously outstanding shares. Typically, ADR depositories refuse to accept deposits of any shares of a class of securities subject to an unregistered public offering outside the U.S. for at least ninety days after the offering date (rather than the completion-of-distribution date). The ninety day period appears to be based in part on the dealer's exemption and in part on the seasoning concepts developed by broker-dealers to determine when a foreign issue has come to rest abroad. After ninety days, the depository would contact the managing underwriter to inquire whether the distribution had been completed. If the distribution had been completed, the depository would begin to accept deposits of underlying shares. If the manager is unable to represent that the distribution has been completed because of lack of knowledge (as opposed to the representation not being true), the depository might begin accepting deposits after ninety days, but would continue to monitor the trading activities in the U.S. and foreign markets. If a large amount of securities were being deposited for ADRs, the depository might then suspend deposits for an additional period of time. See J. Stevenson and W. Williams, Jr., *A Lawyer's Guide to International Business Transactions, United States Legal Aspects of International Securities Transactions, Pt. III, Folio 5 at 80-81 (1980)*. As a result, an arbitrageur would not be able freely to arbitrage price differences between the foreign and U.S. market until the depository bank began to accept deposits of such securities at least ninety days after the foreign offering commenced. (See the discussion of ADR arbitrage in paragraph A.2.f. *infra*.)

(3) The SEC staff has also occasionally suggested that the 1933 Act's registration requirements would apply to sales into the U.S. of previously outstanding securities shortly before or during an unregistered offering in a foreign market of additional securities of the same class if the seller expected to replace the shares sold with substituted shares purchased in the unregistered distribution abroad. This position, if sustained, would require broker-dealers executing sale orders in the U.S. to inquire whether the seller intended to replace some or all of the position by purchasing shares in the unregistered offering. Requiring the registration of such previously outstanding shares in this context, however, would be inconsistent with the accepted view that the concept of fungibility does not apply to the registration requirements of the 1933 Act. As noted above, only the specific securities involved in a public offering and not the entire class of such securities are subject to the 1933 Act's registration requirements. Thus, where adequate precautions have been taken by the ADR depository banks, U.S. broker-dealers should be able to continue trading in previously outstanding securities in the U.S. notwithstanding the existence of a simultaneous unregistered public offering abroad.

e) *Broker-Dealer's Duty of Inquiry*

(1) Notwithstanding the general seasoning guidelines U.S. broker-dealers may choose to follow in connection with the purchase of unregistered securities that have been issued in the Euro-security market, the SEC takes the position that U.S. broker-dealers must bear the responsibility to inquire into the particular facts and circumstances surrounding any such purchase. See Release No. 33-5168 (July 7, 1971); Release No. 33-4445 (February 2, 1962). In effect, the

SEC is using its regulatory power over U.S. broker-dealers to act as policemen in this area, with the support of broad language drawn from several judicial decisions involving egregious fact situations. The U.S. broker-dealer community has in general accepted this role, not only because of the SEC's regulatory authority over them, but also out of an awareness that if a pattern of abuse (i.e., widespread violations of the 1933 Act) were to develop it would likely lead to additional statutory or rulemaking action which might destroy the secondary market in the U.S. for foreign-issued securities.

(2) At least with respect to debt issues that are not usually traded abroad in an anonymous auction market, a U.S. broker-dealer will ordinarily be in the position to know the identity of its seller or the seller's agent, and if the seller or its agent has acted as an underwriter or a selling group member in the initial Eurobond offering, the broker-dealer should want to know whether the securities it would be purchasing were in fact part of the seller's unsold allotment. The broker-dealer might also want to know whether the securities being purchased had been placed in a managed account by the seller. If the securities are being purchased at an abnormal discount, this too might indicate that the broker-dealer might be participating in an underwriter's discount and therefore be participating in a distribution of the securities in the U.S. In sum, any number of factors could put the U.S. broker-dealer on notice that a particular purchase of unregistered Euro-securities, even after a seasoning period, involved a distribution of such securities in the U.S. in violation of the registration and prospectus delivery requirements of the 1933 Act.

f) *One Application of the Problem: ADR Arbitrage.* One example of the problem of trading unregistered foreign securities in the U.S. market occurs in the context of arbitraging foreign securities issued outside the U.S. with ADRs actively traded in the U.S. U.S. broker-dealers engage in arbitrage transactions based on the price differential existing in foreign markets with respect to foreign securities and in the U.S. market for ADRs representing such securities. During the period following an unregistered public distribution of the underlying securities outside the U.S. (whether or not in connection with a simultaneous registered public offering of such securities in the U.S.), a broker-dealer might purchase the underlying securities abroad and contemporaneously sell a corresponding number of ADRs in the U.S., deposit the underlying securities with the ADR depository in return for the ADRs and then deliver the ADRs to the purchaser in the U.S.

Assuming that the broker-dealer purchased for its own account the underlying securities in open market transactions abroad under circumstances where the broker-dealer could not readily distinguish between newly-issued and previously-issued outstanding shares, did not know or have reason to know the identity of the seller and had no arrangement or understanding with a third party regarding the distribution or redistribution of the underlying securities, the broker-dealer should be able to engage in such arbitrage transactions some reasonable time after the commencement of the distribution abroad. Broker-dealers might even engage in such transactions ninety days after completion of the distribution abroad in reliance on the dealer's exemption, but such practice would involve a greater risk than if a longer seasoning period were used. The conceptual question, of course, is whether the broker-dealer would be deemed to be an underwriter (and thus not eligible for the dealer's exemption) by reason of its unwitting purchase of the underlying securities from the issuer or a control person because the 1933 Act defines the term underwriter as a person who makes such a purchase "with a view to . . . the distribution" of such security. But if the broker-dealer effected the purchase on a foreign stock exchange or other anonymous auction market in circumstances in which it could not know the identity of the seller and it in fact had not agreed to and was not acting with the intention of facilitating the distribution, the broker-dealer would not in fact be acting "with a view to

. . . the distribution," should not be considered an underwriter and should not thereby lose the ability to rely on the dealer's exemption. Cf. Release 33-5168 (1971) ("Where it appears that securities to be sold were not acquired by open-market purchases, it must be determined whether their sale is exempted from registration under the Securities Act of 1933."). But see Tomlinson, *Federal Regulation of Secondary Trading in Foreign Securities*, 32 Business Lawyer 463, 475 (1977) (arbitrageurs required to determine source of purchase even in open-market transactions).

g) *Applicability of Rule 144 to Resales of Euro-securities.* To what extent is Rule 144 under the 1933 Act available with respect to resales in the U.S. or to U.S. investors of securities that had been acquired by non-U.S. investors in unregistered foreign offerings? Rule 144 provides a safe-harbor for the resale of restricted securities of an issuer. If all the conditions of the Rule are met, the seller will not be deemed to be an underwriter engaged in a distribution of securities as to which a registration statement was not in effect. In general, the Rule imposes holding period limitations and notice limitations on sellers of restricted securities and requires that sales be made in broker's transactions or transactions directly with a market maker. In addition, certain current public information must be available with respect to the issuer.

(1) Because paragraph (a)(3) of Rule 144 defines the term restricted securities to mean "securities acquired directly or indirectly from the issuer thereof, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering," the SEC staff initially took the position that Rule 144 does not apply to resales of securities distributed in unregistered foreign offerings to non-U.S. investors in reliance on Release 4708 because such offerings are actually public offerings. See *Alden Self-Transit Systems* (avail. January 7, 1977); *Foote, Cone & Belding Communications, Inc.* (avail. May 6, 1976); *Wertpapierdienst GmbH* (avail. September 14, 1973); *The First-Artists Production Co.* (avail. September 1, 1972). Even under these interpretations, however, it would appear that Rule 144 could apply to resales of such unregistered securities if they had been privately placed outside the U.S. with the non-U.S. investors if precautions similar to U.S. private placement procedures have been taken.

(2) For policy reasons, however, the SEC staff more recently appears to have reversed its position and is now willing to grant a no-action letter with respect to resales of unregistered securities that had been initially offered abroad in a public offering in reliance on Release 4708 if the procedures specified in Rule 144 are followed. See *International Income Property, Inc.* (avail. December 12, 1980); *Toth Aluminum Corp.* (avail. January 14, 1980); *Toth Aluminum Corp.* (avail. January 23, 1978); *Toth Aluminum Corp.* (avail. December 6, 1976); *Toth Aluminum Corp.* (avail. February 9, 1976); *Ferronics Inc.* (avail. April 24, 1974). With respect to such resales, however, the SEC staff has imposed the requirement that only domestic broker-dealers may be utilized by the foreign investors to complete the sales. See *International Income Property, Inc.* (avail. December 12, 1980); *Wertpapierdienst GmbH* (avail. September 14, 1973). At least with respect to resales by foreign investors that are not affiliates of the issuer, this latter restriction no longer applies due to the addition of paragraph (k) to Rule 144, which eliminates the amount limitation, and notice and manner of sale requirements of Rule 144 for certain non-affiliated persons. See Release No. 33-6286 (February 6, 1981).



## B. Manipulation of the United States Market Through Trading in Foreign Markets During Distributions of Securities

SEC Rules 10b-6, 10b-7 and 10b-8, issued pursuant to the Securities Exchange Act of 1934, as amended [the 1934 Act], set forth the principles applied by the SEC to determine whether activities by persons participating in a distribution of securities, or in stabilizing in connection therewith, are manipulative or deceptive. These rules were intended to prevent illegitimate market activities by participants in distributions designed only to inflate artificially the market price of securities being distributed. See Release No. 34-5040 (May 18, 1954) (proposed rules); Release No. 34-5159 (April 19, 1955) (revised proposals); Release No. 34-5194 (July 5, 1955) (rules adopted).

Even though these market manipulation rules are triggered only by the use of the means of interstate commerce, the SEC has applied these rules to foreign market transactions by foreign underwriters during distributions because of the participation in such distributions of U.S. broker-dealers and presumably because of the SEC's concern that such foreign market activities will have an effect on the U.S. market. See Brownell, Cohen, Heller, Loss and Stevenson, *Legal Problems of Issuing and Marketing Foreign Securities in the United States*, in *International Financing and Investment 454-60* (McDaniels, ed. 1964); Cohen & Throop, *Investment of Private Capital in Foreign Securities*, in Surrey and Shaw, *A Lawyer's Guide to International Business Transactions 567-72* (1963); VI L. Loss, *Securities Regulation 3777* (1969). The position of the SEC in this area, however, has been developed in only a few no-action letters issued by the SEC staff. The details of these no-action letters appear to have been bargained out on a more-or-less ad hoc basis or to have been derived from ready-made proposals submitted by the interested parties, which may have conceded more than was necessary in order to obtain the blessing of the SEC staff. When imposing its market manipulation concepts on the activities of foreigners in foreign markets, therefore, the SEC has not appeared to appreciate the fact that different countries may have developed different notions about how their securities markets should operate, nor has the SEC directly addressed the substantive question of whether the principal U.S. market for a security, in particular an equity security, can ever be effectively manipulated by trading the security in foreign satellite markets.

### 1. Rule 10b-6

Rule 10b-6 restricts trading activities by persons who are participating or who expect to participate in a distribution. Rule 10b-6 prohibits underwriters, dealers, issuers, and other participants in distributions of securities from bidding for, purchasing, or attempting to induce others to purchase such securities, securities of the same class or series as those being distributed, rights to purchase such securities, or securities into which the distributed securities are immediately convertible or exchangeable until after their participations in such distributions have been completed. Rule 10b-6 contains a number of exceptions for transactions not considered to be manipulative or deceptive, including transactions effected in accordance with the requirements of Rules 10b-7 and 10b-8.

By its terms, Rule 10b-6 applies to such bids or purchases only if they are made "directly or indirectly by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange." Nonetheless, the SEC has applied the rule to trading transactions in foreign markets during simultaneous distributions of securities in the U.S. and in foreign markets and even during distributions abroad of securities actively traded in the U.S. when such distributions were not simultaneously occurring in the U.S.

a) In connection with a registered secondary offering of securities of a U.S. corporation, the SEC staff granted an exemption from Rule 10b-6 to permit European participants in the distribution to purchase such securities outside the U.S. prior to and during the distribution. It was represented that the U.S. market was the principal market for trading the corporation's securities and that the volume of trading in such securities outside the U.S. was inconsequential. It was also represented that most European shareholders effected transactions in such securities in New York, and the prices at which transactions were effected abroad were primarily determined by the New York quotes. The SEC staff granted the exemption from Rule 10b-6 subject to the conditions that the European underwriters did not purchase or sell the corporation's securities in the U.S. or to or from U.S. residents or nationals and did not effect transactions for the "purpose of creating actual or apparent active trading in or raising the price of the stock." *S.S. Kresge Co.* (avail. May 14, 1972).

b) *The British Petroleum Company, Ltd.* (avail. July 14, 1977) involved simultaneous secondary distributions of BP common shares to the public in the U.S. and in Great Britain. The U.S. offering in the form of ADRs, expected to represent approximately twenty-five percent of the securities offered, was registered with the SEC, while the U.K. offering was not. The primary market for the BP shares was on The Stock Exchange, London, but ADRs for such shares were actively traded in the U.S. The U.K. underwriters had agreed to purchase any unsold securities from the selling shareholder, and, in turn, to resell such shares to U.K. and foreign sub-underwriters. Unlike the foreign sub-underwriters who were likely to redistribute the shares they purchased, the U.K. sub-underwriters were expected to hold such shares for investment and not for distribution and were not expected to be acting as a group. The U.K. underwriters had agreed not to bid for or purchase any BP security for their accounts until after the earlier of the completion of the distribution of BP stock by the U.S. underwriters or thirty days from the commencement of the U.S. offering. The SEC staff granted an exemption from Rule 10b-6 to permit the U.K. underwriters to induce purchases of BP shares by others if such transactions were in the ordinary course of business and not for the purpose of creating actual or apparent trading in or raising the price of any BP securities. Owing to the fact that market transactions by sub-underwriters acting independently during the offering period were a standard part of the U.K. distribution system, the trading activities of the U.K. sub-underwriters were not restricted at all during the U.S. distribution, but the foreign sub-underwriters (as well as the U.S. underwriters, of course) were required to comply with the trading restrictions of Rule 10b-6.

c) *The British Petroleum Company, Ltd.* (avail. December 1, 1979) involved a secondary offering of BP shares only in the U.K. where nationals or residents of other countries, including the U.S., would be permitted to submit applications pursuant to the offer subject to certain conditions. Because of the "close relationship between the U.K. and the U.S. markets for BP shares," the BP shares sold in the U.K. underwriting were registered with the SEC under the 1933 Act even though the underwriters and sub-underwriters were required to represent that they were not acquiring shares for redistribution in the U.S. or to residents or nationals of the U.S. The SEC staff granted an exemption to permit the U.K. underwriters to induce others to purchase BP securities on similar conditions to those specified with respect to the 1977 offering described above, and agreed not to recommend enforcement action if the U.K. sub-underwriters engaged in trading activities during the distribution. Trading activities during the distribution by foreign sub-underwriters and the participating U.K. affiliates of U.S. broker-dealers, however, were not exempt from Rule 10b-6.

d) *Dominion Securities Ltd.* (avail. April 13, 1980) involved a request for a no-action letter or an exemption from Rule 10b-6 by Canadian investment dealers with respect to their trading activities in Canada at a time when they would be soliciting proxies with respect to the proposed amalgamation of two Canadian companies to be effected by means of an exchange offer. The acquiring company was a reporting company under Section 15(d) of the 1934 Act, and the target's common shares, approximately thirteen percent of which were held by U.S. residents, were listed on the New York Stock Exchange and primarily traded on The Toronto Stock Exchange. The Canadian dealers agreed not to solicit proxies from U.S. residents or effect transactions for the purpose of creating actual or apparent trading in or raising the price of either companies' securities. The SEC staff granted an exemption from Rule 10b-6 to permit the Canadian dealers to continue trading activities in the securities of the amalgamating companies during the time the dealers solicited proxies for approval of the amalgamation, subject to the following conditions: (i) No bids for or purchases of either companies' securities could be made in the U.S. or from any U.S. resident or national other than on a Canadian stock exchange; (ii) With respect to purchases on a Canadian exchange, no purchase or bid could be effected until after an independent opening transaction or within the last half hour of trading and no purchases could be effected at a price higher than the higher of the highest independent bid price or last sale price; and (iii) Dominion must submit weekly to the SEC lists of purchases of such securities made by the dealers setting forth the number of shares purchased and applicable purchase prices during the preceding week.

e) *Additional Reference: See Johnson, Application of Federal Securities Laws to International Securities Transactions, in Fordham Institute at 163-67.*

## 2. Rule 10b-7

A few no-action letters issued by the SEC staff under Rule 10b-7 also illustrate the attempt by the SEC to require foreign market practices during distributions to conform to U.S. concepts of fairness and freedom from manipulation. Rule 10b-7 sets forth the conditions under which underwriters may make stabilizing bids or purchases in order to prevent or retard a decline in the open market price of a security during a distribution of such security. By its terms, Rule 10b-7 proscribes stabilizing activities not conducted in compliance with the rule only if effected "directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange." The SEC, however, has apparently asserted jurisdiction over foreign stabilizing activities because of the possible collateral effects of such activities on the U.S. market. Perhaps this theory can be justified if a foreign market is the principal trading market for a security that is also traded in the U.S. Where the principal trading market for the security is in the U.S., however, the theory may be less justifiable.

a) In *Alcan Aluminum Ltd.* (avail. June 26, 1976), the SEC staff issued a no-action letter in connection with the simultaneous public offerings in the U.S. and Canada of shares of a Canadian company. The principal market for such shares was the New York Stock Exchange. The offering price of the shares to be offered in Canada was to be determined by converting the U.S. offering price at the prevailing exchange rate, but due to the fluctuations in the exchange rate during the simultaneous offerings, the underwriters proposed to raise the level of the stabilizing bids made in the Canadian market to reflect a decrease in the value of the Canadian dollar with respect to the U.S. dollar or, if a Canadian bid had been reduced to reflect an increase in the value of the Canadian dollar with respect to the U.S. dollar, to raise the bid to reflect a subsequent decrease in the value of the Canadian dollar with respect to the U.S. dollar. The SEC staff took the position that it would not recommend enforcement action with

respect to such increases in the Canadian stabilizing bids, subject to the following conditions:

(i) A Canadian stabilizing bid may be increased only to the extent necessary to reflect a change in the adjusted exchange rate;

(ii) No Canadian stabilizing bid shall be entered at a price above the higher of (a) the then current highest independent bid price for Alcan common shares in the market in which such bid is entered (or, in the case of the Canadian over-the-counter market, the then current highest independent bid price for Alcan common shares on either of the Montreal or Toronto Stock Exchanges), or (b) if the then current lowest independent offer price for Alcan common shares in the market in which such bid is entered is above the last sale price for Alcan common shares in that market, the price of such last sale;

(iii) In no event shall any Canadian stabilizing bid be entered or maintained at a price in excess of the price in Canadian dollars (determined by the adjusted exchange rate) at which a stabilizing bid (if any) for Alcan common shares is then maintained on the NYSE in accordance with the requirements of Rule 10b-7 (the NYSE stabilizing bid), provided, however, that no such Canadian stabilizing bid need be reduced as a consequence of a change in the adjusted exchange rate unless, in the absence of a reduction, that bid would exceed the price of the NYSE stabilizing bid by 1/8th of a Canadian dollar or more;

(iv) To the extent a Canadian stabilizing bid must be rounded up or down to the nearest 1/8th of a Canadian dollar after a change in the adjusted exchange rate or to comply with condition (iii), *supra*, in order to comply with the practice of trading securities at increments of 1/8th of a Canadian dollar prevailing in any Canadian market, such bid shall be rounded down; and

(v) Stabilizing in Alcan common shares is otherwise conducted in accordance with applicable provisions of Rule 10b-7.

b) *Tricentrol Ltd.* (avail. August 2, 1980) involved the underwriting of American Depository Shares of a U.K. company in the U.S. and Canada and, as a result, raised similar issues to those in the *Alcan* no-action letter except that stabilizing bids were to be made in the U.S., Canadian and London markets. The Stock Exchange, London was the principal market for the underlying securities, and the initial U.S. offering price was to be determined by reference to quotations on the London Exchange converted from pounds sterling to U.S. dollars. The initial Canadian offering price would equal the U.S. dollar offering price converted to Canadian dollars. The SEC staff took a no-action position to permit increases in the Canadian and London stabilizing bids to reflect decreases in the value of the Canadian dollar or pound sterling with respect to the U.S. dollar. subject to conditions similar to those specified in the *Alcan* letter, as follows:

(i) A Canadian Stabilizing Bid or a London Stabilizing Bid [may be] increased only to the extent necessary to reflect a change in the Current Exchange Rate.

(ii) No Canadian Stabilizing Bid shall be entered in the Canadian over-the-counter market at a price higher than the then current highest independent bid price for ADSs in such market. After listing on the Toronto Exchange, no such bid shall be entered in the Canadian over-the-counter market at a price higher than the then current highest independent bid for ADSs on such exchange.

(iii) No Canadian Stabilizing Bid shall be entered on the Toronto Stock Exchange at a price above the higher of (A) the then current highest independent bid price for ADSs on such exchange, or (B) the last sale price for ADSs on such exchange if the then current lowest independent asked price for ADSs is above the last sale price.

(iv) No London Stabilizing Bid shall be entered at a price above the higher of (A) the then current highest independent bid price for the Ordinary Shares on The Stock Exchange in London, or (B) the last sale price for Ordinary Shares on such exchange if the then current lowest independent asked price for Ordinary Shares [on such exchange is equal to or higher than the last reported sale price for Ordinary Shares on such exchange].

(v) In no event shall any Canadian Stabilizing Bid be entered or maintained at a price in excess of the United States dollar equivalent in Canadian dollars (determined by applying the Current Exchange Rate) of a U.S. Stabilizing Bid then being maintained in the principal market in the United States in accordance with Rule 10b-7; *provided*, however, that the Canadian Stabilizing Bid need not be reduced after a change in the Current Exchange Rate unless, in the absence of a reduction, that bid (A) if entered in the Canadian over-the-counter market, would exceed the U.S. Stabilizing Bid by \$.05 Canadian or more, or (B) if entered on the Toronto Stock Exchange, would exceed the U.S. Stabilizing Bid by \$.125 Canadian or more.

(vi) In no event shall any London Stabilizing Bid be entered or maintained at a price in excess of the United States dollar equivalent in pounds sterling (determined by applying the Current Exchange Rate) of a U.S. Stabilizing Bid then being maintained in the principal market in the United States in accordance with Rule 10b-7, as adjusted for the fact that one ADS represents two Ordinary Shares; *provided*, however, that the London Stabilizing Bid need not be reduced after a change in the Current Exchange Rate unless, in the absence of a reduction, such bid would exceed the U.S. Stabilizing Bid by two English pence or more.

(vii) If, in entering or adjusting a Canadian Stabilizing Bid or a London Stabilizing Bid to comply with conditions (v) or (vi), *supra*, or after a change in the Current Exchange Rate, it is necessary to round such bids, or any of them, in order to conform them, or any of them, to the practice prevailing (A) in the Canadian over-the-counter market, of trading securities at increments of \$.01 Canadian, (B) on the Toronto Stock Exchange, of trading securities at increments of \$.125 Canadian, or (C) on the Stock Exchange in London, of trading securities at increments of one English pence, then such bid or bids shall be rounded down.

(viii) Stabilization of ADSs and Ordinary Shares is otherwise conducted in accordance with Rule 10b-7.

c) In *Mutsumi Ohta* (avail. September 1, 1972), the SEC staff refused to express an opinion whether Rule 10b-7 would apply to stabilizing bids made by the managing underwriter of a Japanese syndicate on the Tokyo Stock Exchange with respect to securities being distributed only in Japan, where the issuer's securities were listed on the New York Stock Exchange as well as the Tokyo Stock Exchange.

d) *Additional References:* See Liftin, *Concurrent Financing in U.S. and Foreign Markets, Case Study: Tubos de Acero de Mexico, S.A.*, in *Fordham Institute* at 543-51, describing a concurrent registered offering in Mexico and the U.S. by two separate underwriting syndicates, in which the Mexican underwriters had agreed to comply with the requirements of SEC Rules 10b-6, 10b-7 and 17a-2. A recent prospectus concerning an offering of common stock of Genstar Limited, a Canadian corporation, by separate underwriting syndicates of Canadian and U.S. underwriters, indicates that the offering may have been stabilized on the New York, Toronto, Montreal, Alberta, Vancouver, Brussels, Antwerp, Basle, Geneva and Zurich stock exchanges. The Canadian underwriters and selling group members agreed that their stabilizing activities would be conducted at the direction of the lead U.S. underwriter, and that they would comply with the requirements of SEC Rules 10b-6, 10b-7 and 17a-2. See also Klein, *Rights Offerings, "Going Private," and Stock Repurchases by Foreign Private Issuers*, in *Fordham Institute* at 489-92.

## C. Applicability of Other 1934 Act Rules to Insider Trading in Foreign Markets

### 1. Rule 10b-5

Promulgated pursuant to Section 10(b) of the 1934 Act, Rule 10b-5 provides

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

- (a) to employ any device, scheme, or artifice to defraud,
- (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

As interpreted, Rule 10b-5 has been viewed to prohibit, in addition to more traditional fraudulent and manipulative schemes, any purchase or sale of securities based upon material non-public information. Thus, anyone in possession of such information must either disclose such information to the other party in the transaction or refrain from trading the securities. With respect to transactions involving inside information effected in foreign markets, subject matter jurisdiction will not exist under Rule 10b-5 unless the defendant utilized some means of interstate commerce or the mails. See *Sinva v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 48 F.R.D. 385, 386 (S.D.N.Y. 1969) (commodity transactions effected by foreigners in foreign markets not subject to 1934 Act). Where the defendant is a U.S. person or a U.S. corporation, however, the interstate commerce test will most likely be easily satisfied, unlike the situation where foreign broker-dealers without U.S. contacts conduct the transactions wholly abroad.

#### a) *General Principles of the Extraterritorial Reach of Rule 10b-5*

(1) When delineating the extraterritorial reach of the antifraud provisions of the 1934 Act, and in particular Rule 10b-5, U.S. courts have not always applied consistent principles of jurisdiction. Nevertheless, in general, U.S. courts have

applied Rule 10b-5 to international securities transactions if either (i) significant activities took place in the U.S. in connection with a transaction having consequences solely outside of the U.S. (e.g., affecting only non-U.S. investors) or (ii) activities took place solely outside the U.S. in connection with a transaction having a substantial effect within the U.S. These two tests of subject matter jurisdiction are based upon the objective and the subjective principles of jurisdiction expressed in the Restatement (Second) of Foreign Relations Law of the United States [the Restatement].

(a) As set forth in Section 18 of the Restatement, the objective principle of jurisdiction entitles U.S. courts to assert jurisdiction with respect to foreign conduct having substantial, direct and foreseeable effects within the U.S.:

A state has jurisdiction to prescribe a rule of law attaching legal consequences to conduct that occurs outside its territory and causes an effect within its territory, if either

(a) the conduct and its effect are generally recognized as constituent elements of a crime or tort under the law of states that have reasonably developed legal systems, or

(b) (i) the conduct and its effect are constituent elements of activity to which the rule applies; (ii) the effect within the territory is substantial; (iii) it occurs as a direct and foreseeable result of the conduct outside the territory; and (iv) the rule is not inconsistent with the principles of justice generally recognized by states that have reasonably developed legal systems.

In *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206 (2d Cir.), *rev'd in part and remanded*, 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied sub nom. Manley v. Schoenbaum* 395 U.S. 906 (1969), the Second Circuit held that the antifraud provisions of the 1934 Act apply extraterritorially "in order to protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from the effects of improper foreign transactions in American securities [and apply to] transactions regarding stocks traded in the United States which are effected outside the United States, when extraterritorial application of the [1934] Act is necessary to protect American investors." See also *Des Brisay v. Goldfield Corp.*, 549 F.2d 133 (9th Cir. 1977).

(b) As set forth in Section 17 of the Restatement, the subjective principle enables U.S. courts to assert subject matter jurisdiction over conduct within the U.S. even though such conduct has consequences occurring only outside the U.S.:

A state has jurisdiction to prescribe a rule of law

(a) attaching legal consequences to conduct that occurs within its territory, whether or not such consequences are determined by the effects of the conduct outside the territory, and

(b) relating to a thing located, or a status or other interest localized, in its territory.

This subjective principle of jurisdiction would, for example, provide the basis for a U.S. court to assert jurisdiction under Rule 10b-5 against a U.S. issuer or other U.S. person who participated in an offering of securities abroad to non-U.S. investors based upon the activities of such persons that may have taken place in the U.S. in connection with the offering. Applying this subjective principle of jurisdiction to foreign plaintiffs and non-resident American plaintiffs in Rule 10b-5 cases, the Second Circuit summarized its conclusions as follows:

[T]he antifraud provisions of the federal securities laws:  
[a]pply to losses from sales of securities to Americans resident abroad if, but only if, acts (or culpable failures to act) of material importance in the United States have significantly contributed thereto; but

[d]o not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses.

*Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993 (2d Cir.), cert. denied 423 U.S. 1018 (1975). See also, *ITT v. Cornfeld*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,320 (2d Cir. March 17, 1980).

(2) Section 30(b) of the 1934 Act, which exempts from the 1934 Act persons engaged in a "business in securities without the jurisdiction of the United States," provides

The provisions of this title or of any rule or regulation thereunder shall not apply to any person in so far as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this title.

The SEC has never adopted regulations under Section 30(b) and courts have not read the section to limit the extraterritorial application of the antifraud provisions of the 1934 Act. As interpreted in *Schoenbaum, supra*, Section 30(b) was apparently designed to permit brokers, dealers and banks to conduct securities transactions through foreign securities exchanges without having to comply with the registration and reporting requirements of the 1934 Act. See 405 F. Supp. at 207-08. *Kook v. Crang*, 182 F. Supp. 388 (S.D.N.Y. 1960), applied Section 30(b) to hold that Section 7(c) of the 1934 Act and Regulation T of the Board of Governors of the Federal Reserve System did not apply to transactions in Canadian securities on a Canadian exchange effected by a Canadian broker-dealer on behalf of a U.S. citizen, where the credit was extended in Canada, the securities were held as collateral in Canada, and where the defendant's activities in the United States, including its registration as a broker-dealer with the SEC, were not substantial. *But, cf., United States v. Weisscredit Banca Commerciale E. D'Investimenti*, 325 F. Supp. 1384 (S.D.N.Y. 1971); *UFITEC S.A. v. Carter*, 135 Cal. Rptr. 607 *aff'd* 20 Cal. 3d 238, 571 P.2d 990, 142 Cal. Rptr. 279 (1977).

(3) The fact that U.S. persons or corporations with U.S. shareholders are defrauded by insider transactions taking place abroad should not be sufficient in itself to render the transaction subject to the antifraud provisions of the 1934 Act. In such circumstances, jurisdiction should have to be based upon the conduct of the defendant within the U.S. in reliance on the subjective principle of jurisdiction. See *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1972).

#### b) Specific Applications

(1) With respect to securities traded in both the U.S. market and a foreign market, if a transaction involving inside information took place in the foreign market, a U.S. court may find subject matter jurisdiction to exist by applying the objective jurisdictional test provided that the activities abroad had a damaging effect on U.S. shareholders or had a substantial adverse effect on the U.S. market. See *Schoenbaum, supra*. If the transaction involved an ordinary market transaction on a foreign exchange, however, it is unlikely that the transaction would have a substantial and foreseeable effect within the U.S. unless, perhaps, the principal trading market for the securities was the foreign market.

(2) If the foreigner holding non-public information has caused a U.S. investor to purchase or sell in a foreign market a security that is not traded in the U.S., that foreign defendant would be subject to jurisdiction in the U.S. under Rule 10b-5 only pursuant to the subjective principle of jurisdiction—i.e., if essential acts took place in the U.S. that induced the foreign purchases. See *Leasco, supra*.



(3) With respect to securities traded in the U.S. and in foreign markets, a U.S. court might entertain subject matter jurisdiction in a 10b-5 case pursuant to the subjective principle of jurisdiction based upon conduct of the defendants within the U.S. who fraudulently induced foreign investors to purchase or sell the securities in a foreign market. The Second Circuit's decision in *Bersch*, *supra*, however, indicates that mere preparatory actions in the U.S. are not sufficient to justify the application of the 1934 Act with respect to injury to non-U.S. investors. In such cases, the acts in the U.S. must directly cause the loss. With respect to injury to U.S. investors resident abroad, *Bersch* indicates that for subject matter jurisdiction to exist, acts in the U.S. must significantly contribute to the loss.

c) References: See Johnson, *Application of Federal Securities Laws to International Securities Transactions*, in *Fordham Institute* at 89-172, as well as the cases and articles cited therein.

## 2. Section 16(b)

Section 16(b) of the 1934 Act entitles issuers with securities registered under §12 of the 1934 Act to recover any profits derived by the issuer's officers or directors, or any beneficial owner of more than ten percent of the issuer's equity securities, from purchases and sales or sales and purchases of the issuer's equity securities within a six-month period. What are the limits to the application of Section 16(b) of the 1934 Act to recovering short-swing profits from insiders who traded securities registered under Section 12 of the 1934 Act in multiple markets?

a) If both the purchases and sales are effected in the U.S. market, a U.S. court would entertain subject matter jurisdiction to recover short-swing profits even from a non-U.S. investor based upon the subjective principal of jurisdiction because of the activities occurring in the U.S. See *Roth v. Fund of Funds, Ltd.*, 405 F. 2d 421 (2d Cir. 1968), *cert. denied*, 394 U.S. 975 (1969).

b) Subject matter jurisdiction may not exist, however, for a U.S. court to recover short-swing profits from a non-U.S. investor under Section 16(b), if the investor effected the purchases and sales exclusively on foreign exchanges or in foreign markets. One court has dismissed for lack of *in personam* jurisdiction a Section 16(b) derivative suit on behalf of a Canadian corporation whose securities were listed on the AMEX where the transactions were effected in the Canadian market by Canadian residents. See *Wagman v. Astle*, 308 F. Supp. 497 (S.D.N.Y. 1974). Stressing that no other country has a rule such as Section 16(b) that imposes absolute liability for insider trading without any proof of intent to use inside information, the decision in *Wagman* offers some support for the proposition that, as a matter of subject matter jurisdiction, it might never be appropriate for a U.S. court to apply Section 16(b) to purely foreign transactions effected in foreign markets by foreign nationals. See also *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326, 1334 (2d Cir. 1972) (extraterritorial application of any particular statute is a "question of the interpretation of the particular statute").

c) It is not clear, however, whether a U.S. court would apply Section 16(b) to transactions effected abroad by U.S. residents or nationals, or match purchases or sales by a U.S. investor in the U.S. market with his purchases or sales in foreign markets in order to find liability under Section 16(b). It would seem less likely that a U.S. court would enforce Section 16(b) against a foreign national by matching his purchases and sales in the U.S. market with purchases and sales in foreign markets.

d) Securities of certain foreign issuers that are registered under Section 12 of the 1934 Act are exempt from the provisions of Section 16 of the 1934 Act by virtue of Rule 3a12-3.

### 3. Proposed Rule 13e-2

a) In Release No. 34-17222 (October 17, 1980), the SEC repropoed Rule 13e-2, which would impose certain purchase limitations, antifraud provisions and disclosure requirements in connection with issuer repurchases of preferred or common stock other than those constituting issuer tender offers. The proposed rule's purchase restrictions, which would not apply to privately negotiated purchases, involve volume, price and timing limitations similar to those contained in Appendix C under Rule 10b-6, and, in general, prohibit purchases on any single day through more than one broker or dealer.

b) Issuers with securities registered under Section 12 of the 1934 Act and registered closed-end investment companies [Section 13(e) Issuers] as well as certain affiliated purchasers would be subject to all provisions of the proposed rule, while issuers that are reporting companies under Section 15(d) of the 1934 Act would only be subject to the proposed rule's disclosure requirements. Broker-dealers and other persons acting for Section 13(e) Issuers would be subject only to the proposed rule's antifraud provisions and purchase restrictions.

c) In footnote 53 to the Release, the SEC indicated that the purchase limitations of the rule "would not apply to Rule 13e-2 purchases effected in foreign markets." By implication, at least, it would appear that the SEC takes the position that the other provisions of Rule 13e-2, such as the antifraud and disclosure provisions of the rule, would apply to Rule 13e-2 purchases effected in foreign markets by or on behalf of U.S. or foreign issuers subject to the rule, notwithstanding the fact that the SEC or a U.S. court might not have jurisdiction to enforce Rule 13e-2 in such contexts. Thus, the SEC might take the position that the antifraud provisions of Rule 13e-2 apply to transactions effected abroad by foreign broker-dealers on behalf of Section 13(e) Issuers. It would appear, however, that the antifraud provisions of Rule 13e-2 should apply to foreign broker-dealers in such circumstances only if such transactions have a substantial effect on U.S. investors or the U.S. market (i.e., by application of the objective principle of jurisdiction).

### D. ERISA Restrictions on Ownership by U.S. Plans of Foreign Securities

1. The ownership by U.S. persons of foreign securities (and therefore their participation in both the U.S. and foreign secondary markets for such securities) is often more effectively deterred by legal restrictions other than those contained in the 1933 Act, such as the imposition of withholding taxes, the applicability of legal investment statutes and other laws specifically applicable to certain investors, such as the Employee Retirement Income Security Act of 1974 (ERISA).

2. These other legal restrictions are best illustrated by ERISA, which governs pension and profit sharing plans maintained by private employers in the U.S. Upon the adoption of ERISA in 1974, these plans were prohibited from holding foreign securities outside the U.S. except pursuant to regulations of the Department of Labor. ERISA Section 404(b). Such regulations were not issued until October of 1977. See Fed. Reg. 54122 (October 4, 1977) (Rule 404b-1 adopted); 46 Fed. Reg. 1266 (January 6, 1981) (revisions to Rule 404b-1 adopted). Even now, the regulations are not a wholly satisfactory solution. For example, a plan would

most likely desire to hold foreign securities through foreign clearing agencies, such as Euro-clear, to avoid the transaction costs associated with delivery of physical securities out of Euro-clear. A proposed regulation of the Department of Labor, however, casts doubt on this procedure, at least to the extent that such securities are held through a U.S. broker-dealer, since it would prohibit the holding of securities in the name of a broker-dealer or in a street name, except under circumstances where the broker-dealer holds the securities as trustee for the plan pursuant to an executed trust agreement. See 44 Fed. Reg. 50363, 50366 n.14 (August 28, 1979) (proposing Rules 403a-1 and 401b-1). Another regulation would permit certain U.S. banks to place the plan's foreign securities with foreign sub-custodians provided that the U.S. bank remains liable to the same extent as if it had retained physical possession of the securities in the U.S. The scope of this commitment, in light of such risks as the imposition of currency controls, is unclear, and U.S. banks should proceed with caution. In addition to the legal uncertainties ERISA has created in connection with holding foreign securities abroad, more mundane considerations deter investment by U.S. pension and profit sharing plans in foreign securities. For example, plans must maintain bonds covering foreign custodians holding assets of the plan. Frequently, bonds maintained by plans do not cover foreign custodians, and appropriate riders must be obtained.

#### E. Insider Trading in Foreign Markets

It is worth noting that several foreign countries have also attempted to deal with the problem of insider trading. These countries generally regulate insider trading by means of a criminal statute. See e.g., Tunc, *Insider Trading in France*, in L. Gower, L. Loss and A. Sommer, Jr., *New Trends in Company Law Disclosure 5* (1980). The United Kingdom has recently enacted a comprehensive statute treating these issues. See *Companies Act 1980, Chapter 22, Part V*. See also L. Loss (ed.) *Multinational Approaches--Corporate Insiders* (1976).