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Regulation S and Offshore Capital: Will the New Amendments Rid the Safe Harbor of Pirates?[†]

*Jon B. Jordan**

I. INTRODUCTION

In 1990, the Securities and Exchange Commission (“SEC” or the “Commission”) adopted Regulation S.¹ Regulation S provided that offshore offers and sales of securities would be exempt from the 1933 Securities Act registration requirements as long as certain conditions were met.²

[†] SEC Chairman Arthur Levitt has been quoted as saying that Regulation S was “one safe harbor with too many pirates in it.” Brett D. Fromson, *SEC Tightens Overseas Sales Rules*, WASH. POST, Oct. 11, 1996, at F3 (quoting SEC Chairman Arthur Levitt).

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¹ Offshore Offers and Sales, Securities Act Release No. 33-6863, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,524, at 80,661 (Apr. 24, 1990) [hereinafter Adopting Release]. See also Regulation S – Rules Governing Offers and Sales Made Outside the United States Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.901-230.904 (1990) [hereinafter Original Regulation S].

² See Original Regulation S, 17 C.F.R. §§ 230.901-230.904 (1990). The terms “offshore” and “overseas” as used by this author for purposes of this article generally denote any jurisdiction outside of the United States and should not be construed literally.

Regulation S was intended to make the offshore markets more accessible to domestic issuers and thereby reduce the cost of raising capital overseas.³ The regulation was a significant modification in the securities laws which allowed domestic issuers the chance to compete and raise capital in the global marketplace.

Not long after the regulation was adopted, unscrupulous market participants quickly identified and took advantage of significant loopholes in the regulation. In perhaps the most blatant violation of the intent and spirit of the regulation, issuers created phony offshore shell entities as a means to sell unregistered securities back into the United States. The Commission soon undertook enforcement actions in an attempt to halt these abuses. But despite the Commission's best efforts, these abuses continued. Finally, in 1998, the Commission amended Regulation S in an attempt to stop the abusive practices it had spawned.⁴

This article will explain how the securities laws were prior to Regulation S as they applied to the offshore offer and sale of securities. The regulation as originally adopted and the brand new safe harbors it brought to the laws governing offshore offers and sales will also be explored. Then the subsequent regulatory abuses and concerns in the marketplace surrounding the regulation and the Commission's response to these issues will be discussed. The amendments to Regulation S which eventually served as the Commission's way of halting these problems and the changes they brought to the regulation will be laid out. Finally, this author will give what he believes will be the probable impact of the amendments on problems underlying the regulation as well his recommendations on how to eliminate these problems should they continue to occur after the amendments.⁵

II. REGULATION OF OFFSHORE SECURITIES TRANSACTIONS PRIOR TO REGULATION S

Section 5 of the Securities Act of 1933 (the "Securities Act" or the "Act") requires the registration of any offer or sale of securities involving the use of interstate commerce, absent an exemption.⁶ "Interstate commerce" is defined under the Securities Act to include trade or commerce in

³ See Laurie P. Cohen, *Rule Permitting Offshore Stock Sales Yields Deals that Spark SEC Concerns*, WALL ST. J., Apr. 26, 1994, at C1.

⁴ Offshore Offers and Sales, Securities Act Release No. 33-7505, 63 Fed. Reg. 9632 (Feb. 25, 1998) [hereinafter Amending Release]; Regulation S – Rules Governing Offers and Sales Made Outside the United States Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.901-230.905 (1998) [hereinafter Amended Regulation S].

⁵ It is important to note that this article will mainly focus on equity securities of domestic issuers, as this is the area that has been most affected by the abuses and amendments to the regulation. Equity securities of foreign issuers and debt securities will also be discussed but will not be given the same kind of focus as equity securities of domestic issuers.

⁶ Securities Act of 1933 § 5, 15 U.S.C. § 77e (1994).

securities between the United States and any foreign country.⁷ Considering the definition of interstate commerce in conjunction with the requirements under Section 5, the Securities Act originally purported to apply the registration requirements of Section 5 to securities offerings by domestic issuers to foreign purchasers overseas. However, being that the Securities Act was drafted during a time in which there were few international offerings, the Securities Act as applied to these offerings was often the subject of broad interpretation.⁸

In 1964, the Commission attempted to define the extraterritorial reach of the Securities Act's registration requirements through the promulgation of Release 4708.⁹ In Release 4708, the Commission took the position that the registration requirements under Section 5 were primarily for the protection of American investors.¹⁰ In this regard, the Commission stated that it would not take action based on a failure to register when securities were distributed solely abroad to foreign nationals and such distributions were effected in a manner that would result in the securities coming to rest abroad.¹¹

A number of procedures were employed after the issuance of Release 4708 to ensure that securities sold in reliance on the release were sold to foreign purchasers and came to rest abroad.¹² Such procedures were often the subject of no-action letters by the Commission.¹³ Despite a generous amount of no-action letters, the Commission did not provide its specific

⁷ Securities Act of 1933 § 2(7), 15 U.S.C. § 77(b)(7) (1994).

⁸ See Adopting Release, *supra* note 1, at 80,664.

⁹ Registration of Foreign Offerings by Domestic Issuers, Securities Act Release No. 33-4708 (July 9, 1964), 1964 WL 3661 (S.E.C.) [hereinafter Release 4708]. This release was actually a product of a presidential task force that was appointed in 1963 to develop programs for the increased marketing of domestic securities overseas. *See id.* A report was submitted to the President by the task force on April 27, 1964, which contained, among other things, a recommendation that the Commission publish a release setting forth its position regarding the applicability of the registration requirements of the Securities Act to securities offered by domestic issuers to foreign purchasers. *See id.*

¹⁰ *See id.*

¹¹ *See id.* The Commission came to this decision even though interstate commerce was used in such distributions. *See id.* See also Adopting Release, *supra* note 1, at 80,664.

¹² See Adopting Release, *supra* note 1, at 80,664. These procedures included a 90-day lock-up period on securities before they could be issued in definitive form, agreements by underwriters that they would not sell any unsold allotments within the United States or to U.S. persons, and agreements by underwriters that they would deliver confirmations to other dealers notifying them of the selling restrictions. *See* Edward F. Greene and Jennifer M. Schneck, *Recent Problems Arising under Regulation S*, INSIGHTS, Aug. 1994, at 2.

¹³ See Adopting Release, *supra* note 1 at 80,664 (citing InfraRed Associates, Inc., SEC No-Action Letter, 43 SEC Docket 368 (Sept. 13, 1985); Procter & Gamble Co., SEC No-Action Letter, 43 SEC Docket 364 (Feb. 21, 1985); Fairchild Camera and Instrument International Finance N.V., SEC No-Action Letter, 43 SEC Docket 298 (Nov. 15, 1976); Raymond International Inc., SEC No-Action Letter, 43 SEC Docket 28 (May 28, 1976); Pan American World Airways, Inc. 1975 WL 11264 (S.E.C.) (June 30, 1975); The Singer Company, SEC No-Action Letter, 43 SEC Docket 260 (Aug. 2, 1974)).

view as to when securities issued pursuant to Release 4708 could be resold back into the United States or to U.S. persons.¹⁴ The Commission only advised that such resales could take place as long as they were in compliance with the registration requirements of the Securities Act or an exemption therefrom.¹⁵

The development of active international trading markets and the significant increase in offshore offerings presented a growing number of questions under the U.S. securities laws that could not be answered by Release 4708.¹⁶ This uncertainty caused many domestic corporations to shield themselves from the possibility of sanctions by requesting their own determinations by the Commission regarding the legality of certain offshore offerings prior to actually conducting them.¹⁷ This was a costly avenue to take, but almost a necessity, given the absence of clear guidance by the Commission at the time.

III. ORIGINAL REGULATION S

In response to concerns over the laws relating to raising capital offshore, the Commission adopted Regulation S in 1990.¹⁸ The Commission intended Regulation S to assist large financially-sound corporations in selling securities to long-term foreign investors by exempting them from the registration requirements of the Securities Act.¹⁹ Regulation S clarified the extraterritorial application of Section 5 by providing that securities offered and sold outside the United States would not have to be registered with the Commission.²⁰ In essence, the regulation took a territorial approach to Section 5 by limiting the protective reach of Section 5 to investors that purchased securities within the U.S. markets.²¹ The Commission

¹⁴ See Adopting Release, *supra* note 1, at 80,664.

¹⁵ See *id.* (citing Procter & Gamble Co., *supra* note 13).

¹⁶ See Greene & Schneck, *supra* note 12, at 2; Adopting Release, *supra* note 1, at 80,664.

¹⁷ See Procter & Gamble Co., *supra* note 13; Pan American Airways, Inc., *supra* note 13.

¹⁸ See Original Regulation S, 17 C.F.R. §§ 230.901-230.904 (1990); Adopting Release, *supra* note 1, at 80,662. Richard Breeden, SEC Chairman at the time of adoption, described Regulation S as "a roadmap with clear guide posts that establish a safe harbor for transactions outside the United States." *SEC Adopts Reg. S and Rule 144A, Opening Door to Expanded Era of Global Trading*, INT'L SEC. REG. REP., Apr. 23, 1990 (found on LEXIS, NEWS library, ISRR file) (quoting then SEC Chairman Richard Breeden). Regulation S was originally proposed in 1988, see *Offshore Offers and Sales*, Securities Act Release No. 33-6779, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,242, at 89,123 (June 10, 1988) [hereinafter *Proposing Release*], and re-proposed in 1989, see *Offshore Offers and Sales*, Securities Act Release No. 33-6838, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,426, at 80,209 (July 11, 1989) [hereinafter *Re-proposing Release*].

¹⁹ See Cohen, *supra* note 3, at C1.

²⁰ See *id.* See also Guy P. Lander, *Regulation S – Securities Offerings Outside the United States*, 21 N.C. J. INT'L L. & COM. REG. 339, 346 (1996).

²¹ See Adopting Release, *supra* note 1, at 80,665. The regulation defines a U.S. person as "any natural person resident in the United States." Therefore, instead of protecting U.S.

reasoned that "principles of comity and the reasonable expectations of participants in the global markets" justified reliance on "laws applicable in jurisdictions outside the United States to define requirements for transactions effected offshore."²²

Regulation S generally consists of a series of rules that, if complied with, will in effect exempt offshore offers and sales of securities from the Section 5 registration requirements.²³ The regulation specifically consists of a general statement governing the applicability of the registration requirements to offshore offerings (the "General Statement") and two safe harbors which provide when such offerings and secondary resales of unregistered securities offshore will fall under the provisions of the General Statement.²⁴

It is important to note that Regulation S was amended in 1998 to address various abuses of the regulation.²⁵ The amendments substantially changed the classification of securities covered under the safe harbors and modified some of the requirements needed to comply within the regulation. To determine if these amendments addressed some of the negative aspects of the original regulation, it is important to look at the original regulation and the subsequent abuses in it. Most of the provisions in the original regulation survived the amendments; therefore, many of the requirements and safe harbor provisions underlying the original regulation will also apply to the current amended regulation. The changes that did occur through the amendments will be covered in greater detail later in this article.²⁶

A. The General Statement Providing that Offers and Sales of Securities Outside the United States are not Subject to the Section 5 Registration Requirements.

Rule 901 of Regulation S is a general statement regarding the applicability of the Section 5 registration requirements to offerings conducted off-

citizens wherever they live, as was the case with the extraterritorial approach of Release 4708, Regulation S was intended to protect investors purchasing in the U.S. markets, regardless of whether they are U.S. or foreign nationals. *See id.* at 80,676; Original Regulation S, 17 C.F.R. § 230.902(o)(i) (1990). *See also infra* notes 67-71 and accompanying text. The exception to this rule is that offers and sales of securities "specifically targeted at identifiable groups of U.S. citizens abroad, such as members of the U.S. armed forces serving overseas," will not fall under the Regulation S safe harbors. Original Regulation S, 17 C.F.R. § 230.902(i)(2) (1990). Specifically, such transactions will not meet within the definition of an offshore transaction required under the safe harbors. *See id.* *See also infra* notes 40-41 and accompanying text.

²² Adopting Release, *supra* note 1, at 80,665. In this regard, the Commission basically took the position that investors choose the laws in the markets in which they choose to invest. *See id.*

²³ *See generally* Original Regulation S, 17 C.F.R. §§230.901-230.904 (1990).

²⁴ *See id.*

²⁵ *See* Amending Release, *supra* note 4, at 9632.

²⁶ *See* discussion *infra* Part VI.

shore.²⁷ The General Statement provides that the registration requirements under Section 5 do not apply to the offer or sale of securities outside of the United States.²⁸ The determination as to whether an offer or sale occurred outside of the United States will generally be based upon the facts and circumstances of each case.²⁹ However, the regulation itself provides two safe harbor categories that lay out applicable conditions for when an offer or sale will be considered to have occurred outside of the United States for purposes of the General Statement.³⁰

Before going into the specific requirements underlying the safe harbors, it is important to touch on one of the preliminary notes to Regulation S. Preliminary Note 2 of Regulation S provides that the regulation is not available with respect to “any transaction or series of transactions that, although in technical compliance with the rules, is part of a plan or scheme to evade” the registration provisions of the Act.³¹ This provision in the regu-

²⁷ See Adopting Release, *supra* note 1, at 80,665; Original Regulation S, 17 C.F.R. § 230.901 (1990).

²⁸ See Adopting Release, *supra* note 1, at 80,665. The language in the General Statement specifically states that “for the purposes only of Section 5 of the Act, the terms ‘offer,’ ‘offer to sell,’ ‘sell,’ ‘sale,’ and ‘offer to buy’ shall be deemed to include offers and sales that occur within the United States” and does not “include offers and sales that occur outside of the United States.” Original Regulation S, 17 C.F.R. § 230.901 (1990). “United States” is defined as the United States of America, its territories and possessions, any State of the United States, and the District of Columbia. See *id.* § 230.902(p).

²⁹ See Adopting Release, *supra* note 1, at 80,665. In the original proposed and re-proposed Regulation S, the General Statement had listed specific factors to be considered in determining whether an offer or sale occurred outside the United States. See *id.* These factors included (1) the locus of the constituent elements of the offer or sale; (2) the absence of any directed selling efforts in the United States; (3) the likelihood of the securities coming to rest outside of the United States; and (4) the justified expectation of the parties concerning the applicability of the registration requirements. See Proposing Release, *supra* note 18, at 89,131-33; Re-proposing Release, *supra* note 18, at 80,210. The Re-proposing Release left the original list of factors for consideration but acknowledged that various commentators had criticized different aspects of this list and requested further comment as to whether the entire list should be deleted from the General Statement. See Re-proposing Release, *supra* note 18, at 80,210. See also Gerard R. Boyce and Dan C. Aardal, *Offshore Securities Distributions, Regulation S*, N.Y. L.J., Sept. 14, 1995, at 5. In response to commentators expressing concern about this list, the Commission deleted the list from the General Statement as it was finally adopted. See Adopting Release, *supra* note 1, at 80,666.

³⁰ See Adopting Release, *supra* note 1, at 80,666. It is important to note that the Commission in the Adopting Release seemed to indicate that the General Statement could be used alone as a basis in determining whether the registration provisions of the Securities Act would apply “regardless of whether the conditions of the safe harbor[s] are met.” *Id.* at 80,665. However, the securities practitioner would be wise not to rely solely on the General Statement alone when structuring an offshore securities transaction. Rather, the elements for the safe harbors should be carefully followed to ensure that an offer or sale is outside of the United States, as defined by the General Statement. See generally *id.* at 80,666; Original Regulation S, 17 C.F.R. §§ 230.903-230.904 (1990).

³¹ Original Regulation S, 17 C.F.R. Preliminary Note 2 (1990). In such cases, registration under the Act is required. See *id.* See also Adopting Release, *supra* note 1, at 80,665.

lation is significant in that it is broad enough to allow an enforcement avenue by the SEC for perceived abuses and unintended uses of Regulation S regardless of whether the conditions of the safe harbors are met.

B. Issuer and Resale Safe Harbors Providing Conditions for when an Offer and Sale are Outside the United States for Purposes of the General Statement

Regulation S sets forth two non-exclusive safe harbors for the extraterritorial offer, sale and resale of securities.³² Rule 903 of the regulation provides a safe harbor for issuers conducting offerings outside of the United States (the "issuer safe harbor").³³ Any offer or sale by the issuer, distributor, and any of their respective affiliates or agents that meet the requirements of the issuer safe harbor is considered outside of the United States for purposes of the General Statement.³⁴ Rule 904 of the regulation provides a safe harbor for the offshore resale of unregistered securities (the "resale safe harbor").³⁵ Any offer or sale of securities by any person other than the issuer, distributor, and any of their respective affiliates or agents that meet the requirements of the resale safe harbor is considered outside of the United States for purposes of the General Statement.³⁶ The issuer and resale safe harbors both provide means for qualifying securities transactions as occurring "outside of the United States" for purposes of the General Statement.

1. *Two General Conditions Required Under the Issuer and Resale Safe Harbors: The "Offshore Transaction" and "No Directed Selling Efforts in the United States" Requirements*

There are two general conditions that apply to all offers, sales and resales made in reliance on the issuer or resale safe harbors.³⁷ The first condition is that an offer or sale must be made in an "offshore transaction."³⁸ The second condition requires that there be no "directed selling efforts" in the United States in connection with the offer or sale.³⁹

An offer or sale of securities is made in an offshore transaction if the offer is not made to a person in the United States and either (1) at the time

³² See Original Regulation S, 17 C.F.R. §§ 230.903-230.904 (1990); Adopting Release, *supra* note 1, at 80,666.

³³ See Original Regulation S, 17 C.F.R. § 230.903 (1990); Adopting Release, *supra* note 1, at 80,666.

³⁴ See Adopting Release, *supra* note 1, at 80,666.

³⁵ See Original Regulation S, 17 C.F.R. § 230.904 (1990); Adopting Release, *supra* note 1, at 80,666.

³⁶ See Adopting Release, *supra* note 1, at 80,666.

³⁷ See Original Regulation S, 17 C.F.R. §§ 230.903(a)-(b), 230.904(a)-(b).

³⁸ *Id.* §§ 230.903(a), 230.904(a).

³⁹ *Id.* §§ 230.903(b), 230.904(b).

the buy order is originated the buyer is outside the United States or the seller, and any person acting on its behalf, reasonably believes that the buyer is outside the United States; or (2)(a) for purposes of the issuer safe harbor, the transaction is executed in, on or through a physical trading floor of a foreign securities exchange; or (b) for purposes of the resale safe harbor, the transaction is executed in, on or through the facilities of a designated offshore securities market.⁴⁰ The regulation lists the exchanges that constitute designated offshore securities market(s) for purposes of the requirements of an offshore transaction.⁴¹

⁴⁰ See *id.* § 230.902(i).

⁴¹ Rule 902(a) defines a “designated offshore securities market” to mean:

(1) the Eurobond market, as regulated by the Association of International Bond Dealers; the Amsterdam Stock Exchange; the Australian Stock Exchange Limited; the Bourse de Bruxelles; the Frankfurt Stock Exchange; The Stock Exchange of Hong Kong Limited; The International Stock Exchange of the United Kingdom and the Republic of Ireland, Ltd.; the Johannesburg Stock Exchange; the Bourse de Luxembourg; the Borsa Valori di Milan; the Montreal Stock Exchange; the Bourse de Paris; the Stockholm Stock Exchange; the Tokyo Stock Exchange; the Toronto Stock Exchange; the Vancouver Stock Exchange; and the Zurich Stock Exchange.

(2) any foreign securities exchange or non-exchange market designated by the Commission. Attributes to be considered in determining whether to designate such a foreign securities market, among others, include:

- (i) organization under foreign law;
- (ii) association with a generally recognized community of brokers, dealers, banks, or other professional intermediaries with an established operating history;
- (iii) oversight by a governmental or self-regulatory body;
- (iv) oversight standards set by an existing body of law;
- (v) reporting of securities transactions on a regular basis to a governmental or self-regulatory body;
- (vi) a system for exchange of price quotations through common communications media; and
- (vii) an organized clearance and settlement system.

Id. § 230.902(a). In addition to the 17 foreign exchanges originally specified in Rule 902(a)(1), Rule 902(a)(2) authorizes the SEC to designate additional foreign securities exchanges as “designated offshore securities market[s].” *Id.* § 230.902(a)(2). Since the adoption of Original Regulation S, the SEC’s Division of Corporation Finance, pursuant to specific authority delegated to it under Section 200.30-1(j) of the SEC’s Rules of Practice, has designated, through interpretative letters, an additional ten exchanges as “designated offshore securities market[s].” These exchanges include the Helsinki Stock Exchange, *see* Shearson Lehman Hutton Inc., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 79,498, at 77,529 (July 7, 1990); the Mexican Stock Exchange, *see* Mexican Stock Exchange, SEC No-Action Letter, 1991 WL 490027 (SEC) (Feb. 2, 1991); the Oslo Stock Exchange, *see* Oslo Stock Exchange, SEC No-Action Letter, 1991 WL 276820 (SEC) (Dec. 13, 1991); the Alberta Stock Exchange, *see* Alberta Stock Exchange, SEC No-Action Letter, 1993 WL 142832 (SEC) (Mar. 9, 1993); the Istanbul Stock Exchange, *see* Istanbul Stock Exchange, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 76,810, at 78,258 (Oct. 26, 1993); the Irish Stock Exchange, *see* Irish Stock Exchange, SEC No-Action Letter, 1996 WL 162453 (SEC) (Apr. 5, 1996); the Copenhagen Stock Exchange, *see* Copenhagen Stock Exchange, SEC No-Action Letter, 1996 WL 382557 (SEC) (July 9, 1996); the Bermuda Stock Exchange, *see* Bermuda Stock Exchange, SEC No-Action Letter, 1996 WL 591165 (SEC) (Oct. 11, 1996); the Stock Exchange of Singapore Ltd., *see* Stock Exchange of Singapore Ltd., SEC No-Action Letter, 1997 WL 149357 (SEC) (Apr. 1, 1997); and the Warsaw Stock

A person making an offer or sale otherwise in accordance with the conditions of the issuer safe harbor will be unable to rely on that safe harbor if any directed selling efforts are being made in the United States by an issuer, distributor, or any of their respective affiliates or agents.⁴² With respect to the resale safe harbor, any directed selling efforts by the seller and any of its affiliates or agents will preclude reliance on the resale safe harbor by that seller.⁴³ Directed selling efforts are those activities that could reasonably be expected to have the effect of conditioning the market in the United States for any of the securities being offered or sold in reliance on Regulation S.⁴⁴

If a transaction meets the two general conditions of an (1) offshore transaction and (2) no directed selling efforts in the United States then it might qualify under the issuer or resale safe harbor.⁴⁵ The issuer and resale safe harbors delineate supplemental conditions, if any, beyond the two general conditions that are needed to meet the requirements under the preferred safe harbor category.

Exchange, see Warsaw Stock Exchange, SEC No-Action Letter, 1997 WL 277246 (SEC) (May 22, 1997). See generally *Update of Regulation S "Designated Offshore Securities Market,"* FIN. REG. REP. (found on LEXIS, NEWS (June 1996).

⁴² Original Regulation S, 17 C.F.R. § 230.903(b) (1990). See also Adopting Release, *supra* note 1, at 80,668. Under the issuer safe harbor, directed selling efforts in the United States may not be made during the period the issuer, distributor, their respective affiliates or any persons acting on their behalf are offering and selling the securities and/or during the restricted period for offerings falling under the second and third issuer safe harbor categories. See Adopting Release, *supra* note 1, at 80,668.

⁴³ Original Regulation S, 17 C.F.R. § 230.904(b) (1990). See also Adopting Release, *supra* note 1, at 80,668. Directed selling efforts by any other person will not affect the seller's ability to rely on the resale safe harbor. See Adopting Release, *supra* note 1, at 80,668.

⁴⁴ Original Regulation S, 17 C.F.R. § 230.902(b)(1) (1990). Activities such as mailing printed materials to U.S. investors, conducting promotional seminars in the United States or placing advertisements with radio or television stations broadcasting into the United States or in publications with a general circulation in the United States, which discuss the offering or are otherwise intended to condition, or could reasonably be expected to condition, the market for the securities, constitute directed selling efforts in the United States. See Adopting Release, *supra* note 1, at 80,668. A publication with a general circulation in the United States is one that is printed primarily for distribution in the United States or that has had, during the preceding twelve months, an average circulation in the United States of 15,000 or more copies an issue. See Original Regulation S, 17 C.F.R. § 230.902(k)(1) (1990). When an issuer is not a reporting issuer, the Commission has deemed the distribution or publication of information about the issuer or its securities to be more significant due to the possible lack of publicly available information about the issuer. See Adopting Release, *supra* note 1, at 80,669-70. Therefore the Commission has cautioned that distributors and their affiliates should exercise even greater caution in the publication or distribution of information concerning nonreporting issuers and their securities. See *id.* See also ROBERT J. HAFT, ANALYSIS OF KEY SEC NO-ACTION LETTERS 2-5 (1996-97 ed.).

⁴⁵ See Original Regulation S, 17 C.F.R. §§ 230.903(a)-(b), 230.904(a)-(b) (1990).

2. Issuer Safe Harbor

The issuer safe harbor generally applies to offers and sales by issuers, distributors, their affiliates, and any persons acting on their behalf.⁴⁶ The issuer safe harbor is divided into three categories with varying procedural safeguards imposed on each.⁴⁷ The criteria used to divide securities into these three categories reflect the degree of information available to U.S. investors and the likelihood of the securities flowing back into the United States.⁴⁸ Category One generally applies to the securities of non-U.S. issuers including the securities of foreign issuers with no substantial market interest in the United States for their securities.⁴⁹ Category Two applies to the securities of foreign reporting issuers with a substantial market interest in the United States for their securities, and certain securities issued by nonreporting foreign issuers.⁵⁰ Category Two originally applied to the securities of domestic reporting issuers but the amendments later placed these securities into the third issuer safe harbor category.⁵¹ Category Three applies to the securities of all other issuers not covered under the first two issuer safe harbor categories, including the securities of domestic nonreporting issuers and foreign nonreporting issuers with a substantial market interest in the United States for their securities.⁵²

(a) Category One

The first issuer safe harbor category applies to securities offered and sold by foreign issuers⁵³ with no "substantial U.S. market interest" for their

⁴⁶ See Original Regulation S, 17 C.F.R. § 230.903 (1990).

⁴⁷ See *id.* § 230.903(c)(1)-(3).

⁴⁸ See Adopting Release, *supra* note 1, at 80,671. For domestic issuers, the issuer safe harbor originally prescribed fewer restrictions for securities offered by reporting issuers under Category Two than for nonreporting issuers under Category Three. See Original Regulation S, 17 C.F.R. § 230.903(c)(2)-(3) (1990). These differences were reflective of the Commission's view that investors in securities issued by reporting issuers had the protection of the Exchange Act periodic reporting requirements whereas investors in nonreporting issuers did not. See Adopting Release, *supra* note 1, at 80,675. The amendments changed this distinction in the regulation between domestic reporting and nonreporting issuers when domestic reporting issuers were moved into the third issuer safe harbor category. See *infra* note 236 and accompanying text.

⁴⁹ See Original Regulation S, 17 C.F.R. § 230.903(c)(1) (1990). The exception to this is that Category One securities offered and sold pursuant to employee benefit plans established and administered in accordance with the laws of a foreign country can be securities of domestic issuers. See *id.* § 230.903(c)(1)(iv). See also *infra* note 57 and accompanying text.

⁵⁰ See Original Regulation S, 17 C.F.R. § 230.903(c)(2) (1990).

⁵¹ See *infra* note 236 and accompanying text.

⁵² See Original Regulation S, 17 C.F.R. § 230.903(c)(3) (1990).

⁵³ A "foreign issuer" is generally any issuer that is (1) a "foreign government;" (2) a "national of any foreign country;" or (3) a "corporation or other organization incorporated or organized under the laws of any foreign country." *Id.* § 230.902(f).

securities,⁵⁴ securities offered and sold in "overseas directed offerings,"⁵⁵ securities backed by the full faith and credit of a foreign government,⁵⁶ and securities offered and sold pursuant to certain employee benefit plans established and administered in accordance with the laws of a foreign country.⁵⁷ Offers and sales under this category require no additional conditions other than the two general conditions of an offshore transaction and no directed selling efforts in the United States.⁵⁸ This category is the least restrictive of the issuer safe harbor categories because securities covered

⁵⁴ *Id.* § 230.903(c)(1)(i)(A)-(D). A "substantial U.S. market interest" in a class of a foreign issuer's equity securities is defined to exist where "at the commencement of the offering" (1) the "securities exchanges and inter-dealer quotation systems in the United States in the aggregate constitute the single largest market for such securities in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation;" or (2) "20 percent or more of the trading in the class of securities took place in, on or through the facilities of securities exchanges and inter-dealer quotation systems in the United States and less than 55 percent of such trading took place in, on or through the facilities of securities markets of a single foreign country in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation." *Id.* § 230.902(n)(1)(i)-(ii). See also Adopting Release, *supra* note 1, at 80,673.

⁵⁵ See Original Regulation S, 17 C.F.R. § 230.903(c)(1)(ii) (1990). An "overseas directed offering" is: (1) "an offering of securities of a foreign issuer that is directed into a single country other than the United States to the residents thereof and that is made in accordance with the local laws and customary practices and documentation of such country;" or (2) "an offering of non-convertible debt securities," asset-backed securities or non-participating preferred stock of domestic issuers directed to residents of a single foreign country "in accordance with the local laws, and customary practices and documentation of such country, provided that the principal and interest of the securities (or par value, as applicable) are denominated in a currency other than U.S. dollars and such securities are neither convertible into U.S. dollar-denominated securities nor linked to U.S. dollars (other than through related currency or interest rate swap transactions that are commercial in nature) in a manner that in effect converts the securities to U.S. dollar-denominated securities." *Id.* § 230.902(j). See also Adopting Release, *supra* note 1, at 80,674.

⁵⁶ See Original Regulation S, 17 C.F.R. § 230.903(c)(1)(iii) (1990). A "foreign government" is "the government of any foreign country or of any political subdivision of a foreign country, provided that such person would qualify to register securities under the Act on Schedule B." *Id.* § 230.902(e).

⁵⁷ See *id.* § 230.902(c)(1). Offerings of securities to employees of a domestic or foreign issuer pursuant to an "employee benefit plan" established and administered in accordance with the laws of a foreign country may be made under the first issuer safe harbor category provided that: (1) "the securities are issued in compensatory circumstances for bona fide services rendered to the issuer or its affiliates in connection with their businesses and such services are not rendered in connection with the offer and sale of securities in a capital-raising transaction;" (2) "any interests in the plan are not transferable other than by will or the laws of descent or distribution;" (3) "the issuer takes reasonable steps to preclude the offer and sale of interests in the plan or securities under the plan to U.S. residents other than employees on temporary assignment in the United States;" and (4) "documentation used in connection with any offer pursuant to the plan contains a statement that the securities have not been registered under the Act and may not be offered or sold in the United States unless registered or an exemption from registration is available." *Id.* § 230.903(c)(1)(iv).

⁵⁸ See *id.* § 230.903(c)(1).

under it are considered to pose the least risk to domestic investors in terms of their potential of flowing back into the United States.⁵⁹

(b) Category Two

The second issuer safe harbor category originally applied to the securities of domestic reporting issuers, securities of foreign reporting issuers with a substantial market interest in the United States for their securities, debt securities of nonreporting foreign issuers, and non-participating preferred stock and asset-backed securities of nonreporting foreign issuers.⁶⁰ Significantly, this category originally applied to the equity securities of domestic reporting issuers and foreign reporting issuers with a substantial market interest in the United States for their securities.⁶¹ Domestic reporting issuers were later moved into the third issuer safe harbor category with the amendments to the regulation.⁶²

Securities under Category Two are subject to the two general conditions of an offshore transaction and no directed selling efforts in the United States, as well as an additional set of selling restrictions.⁶³ These selling

⁵⁹ See Adopting Release, *supra* note 1, at 80,672. In this regard, it is important to realize that the sale of unregistered Regulation S securities into the U.S. by dealers during the 40 days following the first date when such securities were offered to the public would not be exempt under Section 4(3) of the Securities Act. *Id.* at 80672 n.84; Securities Act of 1933 § 4(3), 15 U.S.C. § 77(d)(3) (1994).

⁶⁰ See Original Regulation S, 17 C.F.R. § 230.903(c)(2) (1990).

⁶¹ See Original Regulation S, 17 C.F.R. § 230.903(c)(2) (1990). These issuers are generally required to file reports with the SEC under the Exchange Act. A "reporting issuer" is specifically defined in the regulation as an issuer, other than an investment company, registered or required to register under the 1940 Act that: (1) "has a class of securities registered pursuant to Section 12(b) or 12(g) of the Exchange Act, 15 U.S.C. § 78l(b) or § 78l(g) (1997); or is required to file reports pursuant to Section 15(d) of the Exchange Act, 15 U.S.C. § 78o(d) (1997);" and (2) "has filed all the material required to be filed pursuant to Section 13(a) or 15(d) of the Exchange Act, 15 U.S.C. §§ 78m(a) and 78o(d) (1997), for a period of at least twelve months immediately preceding the offer or sale of securities made in reliance upon . . . Regulation S (or for such shorter period that the issuer was required to file such material)." Original Regulation S, 17 C.F.R. § 230.902(l) (1990). For a definition of "substantial U.S. market interest," see *supra* note 54 and accompanying text. Foreign issuers (reporting and nonreporting) with no substantial U.S. market interest for their securities are covered under Category 1. See Original Regulation S, 17 C.F.R. § 230.903(c)(1)(i) (1990).

⁶² See *infra* note 236 and accompanying text.

⁶³ See Original Regulation S, 17 C.F.R. § 230.903(c)(2)(ii)-(iv) (1990). These selling restrictions were "designed to protect against an indirect unregistered public offering in the U.S. during the period the market is most likely to be affected by selling efforts offshore." Adopting Release, *supra* note 1, at 80,675. The Commission had the view that if a reporting issuer's securities were to flow back into the United States following the end of a restricted period, the information relating to such securities publicly available under the Exchange Act would generally be sufficient enough to ensure investor protection. See *id.*

restrictions can generally be divided into transactional restrictions and offering restrictions.⁶⁴

The transactional restrictions under Category Two require that securities sold prior to the expiration of a 40 day restricted period not be offered or sold to or for the benefit of a U.S. person.⁶⁵ Distributors selling securities to certain securities professionals during the restricted period must send a confirmation or other notice to the purchaser stating that the purchaser is subject to the same restrictions on offers and sales that apply to the selling distributor.⁶⁶

The definition of a "U.S. person" plays an important role in the transactional restrictions as well as in the entire regulation. Under Regulation S the definition of a U.S. person focuses on residency rather than citizenship.⁶⁷ Regulation S specifically defines a U.S. person as "any natural person resident in the United States."⁶⁸ Therefore any domestic or foreign national resident in the United States is automatically considered a U.S. person under Regulation S.⁶⁹ In the case of corporations, the place of incorporation or organization generally controls.⁷⁰ The Commission has noted, however, that a corporation incorporated or organized in a foreign jurisdiction by a U.S. person for purposes of investing in securities not registered with the Commission will still fall under the definition of a U.S. person for purposes of Regulation S.⁷¹

There are two offering restrictions, in addition to the transactional restrictions, that must be adhered to under Category Two.⁷² These offering restrictions also apply to securities covered under Category Three and must

⁶⁴ See Adopting Release, *supra* note 1, at 80,676.

⁶⁵ See Original Regulation S, 17 C.F.R. § 230.903(c)(2)(iii) (1990). Persons relying on this category must ensure "by whatever means they choose" that any non-distributor they sell securities to is a non-U.S. person and is not purchasing for the "account or benefit of a U.S. person." Adopting Release, *supra* note 1, at 80,676. A restricted period generally is a "period that commences on the later of the date upon which the securities were first offered to persons other than distributors in reliance upon Regulation S or the date of closing of the offering, and expires a specified period of time thereafter." Original Regulation S, 17 C.F.R. § 230.902(m) (1990).

⁶⁶ See Original Regulation S, 17 C.F.R. § 230.903(c)(2)(iv) (1990).

⁶⁷ See *id.* § 230.902(o).

⁶⁸ *Id.* § 230.902(o)(1)(i).

⁶⁹ See generally Adopting Release, *supra* note 1, at 80,676. The Adopting Release states as an example that a French citizen resident in the United States is deemed a U.S. person for purposes of Regulation S. See *id.*

⁷⁰ See Original Regulation S, 17 C.F.R. § 230.902(o)(1)(ii) (1990). An agency or branch of a foreign entity located in the United States is deemed a U.S. person. See *id.* § 230.902(o)(1)(v).

⁷¹ See *id.* § 230.902(o)(viii)(A)-(B).

⁷² See *id.* § 230.903(c)(2)(ii). The offering restrictions in the original regulation were outlined under Rule 902(h). See *id.* § 230.902(h).

be adopted with regard to the entire offering.⁷³ The first offering restriction requires that every distributor agree in writing that offers and sales made prior to the expiration of the restricted period will be conducted in compliance with the safe harbor provisions governing Regulation S, or pursuant to registration or an exemption.⁷⁴ The second offering restriction requires that offering materials and documents used in connection with the offer and sale of Regulation S securities during the restricted period include statements "to the effect that the securities have not been registered" and "may not be offered or sold in the United States or to U.S. persons" unless they are registered or there is an exemption.⁷⁵

(c) Category Three

Securities not covered under the first two issuer safe harbor categories fall into the residual third issuer safe harbor category.⁷⁶ Securities in this category include equity securities of domestic nonreporting issuers and of foreign nonreporting issuers with a substantial market interest in the United States for their securities.⁷⁷ The procedures under Category Three are more stringent than the other two categories because they are intended to protect against unregistered U.S. distributions where there is a significant likeli-

⁷³ See *id.* § 230.903(c)(3)(i); Adopting Release, *supra* note 1, at 80,679. Offering restrictions are essentially "procedures set up to ensure compliance with the transactional restrictions." Adopting Release, *supra* note 1, at 80,679.

⁷⁴ See Original Regulation S, 17 C.F.R. § 230.902(h)(1) (1990).

⁷⁵ See *id.* § 230.902(h)(2). Such offering materials and documents include, among other things, prospectuses, offering circulars, and advertisements. See *id.* § 230.902(h)(2)(i)-(iii).

⁷⁶ See *id.* § 230.903(c)(3); Adopting Release, *supra* note 1, at 80,679.

⁷⁷ See Original Regulation S, 17 C.F.R. § 230.903(c)(3) (1990). Domestic reporting issuers are later included in this category with the amendments. See *infra* note 247 and accompanying text. It is important to note that Category Three is divided between debt and equity securities. See Original Regulation S, 17 C.F.R. § 230.903(c)(3)(ii)-(iii) (1990). In the case of debt securities, the two general conditions of an offshore transaction and no directed selling efforts in the U.S. have to be followed along with the offering restrictions that are generally required for Category Two securities. See *id.* § 230.903(c)(3)(i). See also *supra* notes 72-75 concerning offering restrictions. Debt securities that fall under Category Three are only subject to a 40 day restricted period and have to be represented by temporary global securities not exchangeable for definitive securities until the expiration of this restricted period. See Original Regulation S, 17 C.F.R. § 230.903(c)(3)(ii)(A)-(B). Upon expiration of the restricted period, "persons exchanging their temporary global securit[ies] for . . . definitive securit[ies] are required to certify beneficial ownership by: a non-U.S. person or a U.S. person who purchased securities in a transaction that did not require registration under the Securities Act." Adopting Release, *supra* note 1, at 80,680 (citing requirements of 17 C.F.R. § 230.903(c)(3)(ii)(B)). Distributors selling Category Three debt securities are also required to provide notice to purchasers that such purchasers are subject to the same restrictions as those that applied to the distributor. See Original Regulation S, 17 C.F.R. § 230.903(c)(3)(iv) (1990). For purposes of this article the terms "Category Three" or "Category Three securities" will generally focus on equity securities covered under Category Three.

hood of the securities flowing back into the United States and there is little information about the issuer in the marketplace.⁷⁸

Securities under Category Three must meet the two general conditions of an offshore transaction and no directed selling efforts in the United States.⁷⁹ They are also required to meet the two offering restrictions required under Category Two, with the exception that Category Three securities are subject to a one year, rather than a 40 day, restricted period.⁸⁰

Category Three securities are subject to a set of transactional requirements that are more rigorous than those required under Category Two.⁸¹ In addition to the restrictions noted above,⁸² purchasers of these securities, other than distributors, are required to certify that they are not U.S. persons and are not acquiring the securities for the account or benefit of a U.S. person.⁸³ These purchasers are also required to agree to resell these securities only in compliance with the rules governing Regulation S, or pursuant to registration or any other exemption.⁸⁴

Other Category Three transactional restrictions require that a legend be placed on the securities of Category Three domestic issuers stating that transfers in these securities are prohibited except in accordance with the provisions governing Regulation S.⁸⁵ The issuer, by contract, provision in its bylaws, or other comparable document, must also refuse to register any transfer of Category Three securities not made in accordance with Regulation S.⁸⁶ Distributors selling equity or debt securities prior to the expiration of the restricted period additionally are required to notify purchasers that they are subject to the same restrictions as the distributor.⁸⁷

⁷⁸ See Adopting Release, *supra* note 1, at 80,679.

⁷⁹ See Original Regulation S, 17 C.F.R. § 230.903(c)(3) (1990).

⁸⁰ See *id.* §§ 230.902(h), 230.903(c)(3)(i), 230.903(c)(3)(iii)(A). See also *supra* notes 72-75 concerning the offering restrictions. These offering restrictions are later modified with the amendments as they apply to domestic issuers covered under Category Three. See *infra* notes 266-71 and accompanying text.

⁸¹ See Original Regulation S, 17 C.F.R. § 230.903(c)(3)(ii)-(iv) (1990). These transactional restrictions are similar to those that evolved under the no-action letters interpreting Release 4708, and distinguish between debt and equity securities. See Adopting Release, *supra* note 1, at 80,679. Some of these transactional restrictions are also later modified with the amendments as they apply to domestic issuers covered under Category Three. See *infra* notes 255-65 and accompanying text.

⁸² See Original Regulation S, 17 C.F.R. § 230.903(c)(3)(iii)(A) (1990).

⁸³ See *id.* § 230.903(c)(3)(iii)(B)(1).

⁸⁴ See *id.* § 230.903(c)(3)(iii)(B)(2). This transactional restriction is later modified with the amendments. See *infra* notes 258-59 and accompanying text.

⁸⁵ See Original Regulation S, 17 C.F.R. § 230.903(c)(3)(iii)(B)(3) (1990). This transactional restriction is later modified with the amendments. See *infra* notes 260-61 and accompanying text.

⁸⁶ Original Regulation S, 17 C.F.R. § 230.903(c)(3)(iii)(B)(4) (1990).

⁸⁷ See *id.* § 230.903(c)(3)(iv). Two types of nonreporting domestic securities that are a category of their own include non-convertible, non-participating preferred stock and asset-backed securities. See Original Regulation S, 17 C.F.R. § 230.903(c)(4) (1990). These

3. Resale Safe Harbor

Sales of unregistered securities require an exemption from registration, regardless of whether the sale is made by the issuer or a subsequent purchaser.⁸⁸ While there are exemptions that could be utilized for the resale of unregistered securities, the resale safe harbor of Rule 904 of Regulation S provides one of the easiest methods.⁸⁹ The resale safe harbor essentially provides a safe harbor for the offshore resale of unregistered securities by persons other than the issuer, distributor or any of their respective affiliates or agents.⁹⁰ Persons eligible for the resale safe harbor only have to meet the two general conditions: the transaction must take place offshore, and no directed selling efforts may occur in the United States.⁹¹ If these general conditions are met, then the resale is considered to have occurred outside of the United States for purposes of the General Statement and the registration requirements.⁹²

Regulation S was intended to provide domestic corporations with easier access to the offshore securities markets and greater leverage in the growing international financial marketplace.⁹³ These provisions would in-

types of securities are subject to the same restrictions as debt securities covered under the third category, including a restricted period of 40 days rather than one year. *See id.* *See also* Adopting Release, *supra* note 1, at 80,679.

⁸⁸ *See* Securities Act of 1933 § 5, 15 U.S.C. § 77(e) (1994).

⁸⁹ *See* Original Regulation S, 17 C.F.R. § 230.904 (1990). The most significant exemptions that could apply would be those covered under Section 4(1) of the Securities Act and Rule 144. Section 4(1) provides that the registration requirements of the Securities Act do not apply to transactions by any person other than an issuer, underwriter or dealer. Securities Act of 1933 § 4(1), 15 U.S.C. § 77d(1) (1994). Rule 144 provides a non-exclusive safe-harbor under Section 4(1). Rule 144, Persons Deemed Not to Be Engaged in a Distribution and Therefore Not Underwriters, 17 C.F.R. § 230.144 (1997) [hereinafter Rule 144]. Rule 144 restricts resales of unregistered domestic securities bought in private placements, requires the filing of financial reports, and mandates at least a one year holding period before the securities can be resold. *See id.* § 230.144(c)-(e).

⁹⁰ *See* Original Regulation S, 17 C.F.R. § 230.904 (1990). An officer or director of an issuer or distributor is eligible to rely upon the resale safe harbor if the sole reason such officer or director may be deemed an affiliate is by virtue of position, provided that no special selling compensation is paid in connection with the offer and sale by such officer or director. *See id.* § 230.904(c)(2); Adopting Release, *supra* note 1, at 80,680.

⁹¹ *See* Original Regulation S, 17 C.F.R. § 230.904(a)-(b) (1990).

⁹² *See id.* § 230.904. Securities professionals are subject to two additional conditions for the resale safe harbor. *See id.* § 230.904(c)(1). One of the conditions requires that, if the securities being resold do not fall under Category One, and the resale is made prior to the expiration of any applicable restricted period, then the securities professional or any person acting on his or her behalf may not knowingly offer or sell such securities to a U.S. person. *See id.* § 230.904(c)(1)(i). Another condition requires that, if the selling securities professional or a person acting on his or her behalf knows the purchaser of the securities is a securities professional, then the seller is required to send a confirmation or other notice of the applicable restrictions to the purchaser. *See id.* § 230.904(c)(1)(ii). *See also* Adopting Release, *supra* note 1, at 80,680-81.

⁹³ Cohen, *supra* note 3, at C1.

crease U.S. competitiveness offshore and lower the cost of raising capital abroad.⁹⁴ Regulation S was also designed to provide certainty for issuers that did not exist under Release 4708 and its subsequent no-action letters.⁹⁵ Unfortunately, with the benefits of the regulation also came unexpected abuses. Many corporations and individuals found ways to profit from unintended loopholes in the regulation. While it is expected that the financial marketplace will always find ways to profit from the financial instruments and laws available in the marketplace, the loopholes found and used in many cases were fraudulent or contrary to the intent of the SEC when it adopted the regulation.⁹⁶ Unfortunately, these abuses tainted the validity of Regulation S as a qualified and efficient means for raising capital overseas and eventually led the Commission to amend the regulation in its entirety.⁹⁷

IV. REGULATORY PROBLEMS AND CONCERNS IN THE MARKETPLACE INVOLVING OFFERINGS UNDER REGULATION S

Regulation S was intended to be used by financially sound, domestic corporations for the placement of securities with long-term offshore investors.⁹⁸ In this capacity, the regulation was designed to allow and encourage domestic issuers to compete in the global marketplace. However, only a year after the adoption of Regulation S, the SEC filed its first enforcement action involving securities violations associated with the regulation.⁹⁹ Other enforcement actions soon followed, and it became apparent

⁹⁴ R. Brandon Asbill, *Securities Regulation – Great Expectations and the Reality of Rule 144A and Regulation S: The SEC’s Approach to the Internationalization of the Financial Marketplace*, 21 GA. J. INT’L & COMP. L. 145, 161-62 (1991).

⁹⁵ See *supra* notes 9-17 and accompanying text.

⁹⁶ See generally Problematic Practices Under Regulation S, Securities Act Release No. 33-7190, 60 Fed. Reg. 35,663, 35,665 (June 27, 1995) [hereinafter Problematic Practices Release].

⁹⁷ See *infra* notes 205-09 and accompanying text.

⁹⁸ See Cohen, *supra* note 3, at C1.

⁹⁹ See SEC v. Westdon Holding & Inv., Inc., Securities Act Litigation Release No. 13,085, 50 SEC Docket 229 (S.D.N.Y. Nov. 7, 1991). In *Westdon*, the SEC filed a civil injunctive action against Westdon Holding & Investment Inc. (“Westdon”) and others, alleging that Westdon had purchased a large amount of unregistered securities at a fraction of the market price from an issuer in reliance on Regulation S. See *id.* at 229. According to the allegations by the SEC, Westdon, a Delaware corporation with offices in Rotterdam, Netherlands, had agreed with the issuer that such shares would not be resold by Westdon for five years. See *id.* However, immediately upon receiving the shares, Westdon allegedly began taking steps to illegally distribute the unregistered shares to unsuspecting purchasers in the United States without the benefit of any valid exemption from registration. See *id.* Seven days after the SEC filed the case, the court issued a preliminary injunction and asset freeze against Westdon and others named as defendants. See SEC v. Westdon Holding & Inv., Inc., Securities Act Litigation No. 13,088, 50 SEC Docket 307 (S.D.N.Y. Nov. 14, 1991). On June 5, 1992, the Court entered a Final Judgment of Permanent Injunction against one of the defendants. See SEC v. Westdon Holding & Inv., Inc., Securities Act Litigation Release No. 13,263, 51 SEC Docket 1060 (S.D.N.Y. Jun. 5, 1992). The defendant consented to the entry of a final judgment without admitting or denying the SEC’s allegations and was en-

that there were loopholes in the regulation that exposed it to various abuses. Concerns on Wall Street also began to focus on the regulation's impact on the stock market. It is important to analyze these regulatory and marketplace concerns that, directly and indirectly, led to amendments in Regulation S. Close attention to these factors should provide some insight as to whether the amended regulation will fare better than its predecessor.

A. Regulatory Problems Involving Regulation S

1. *Illegal Resales Within the Restricted Period*

The most basic securities violation that can occur under Regulation S is the resale of Regulation S securities back into the United States prior to the end of a restricted period.¹⁰⁰ Any such resale, absent an exemption or registration, is a clear violation of the regulation.¹⁰¹ Nevertheless, foreign purchasers will sometimes ignore these restricted periods and sell their securities back into the United States without waiting out the holding periods required under Regulation S.¹⁰²

The securities profession needs to be aware of transactions involving securities offered under Regulation S because liability can arise when the restricted periods are not respected. Such liability occurred in 1996 when the regulatory arm of the National Association of Securities Dealers (the NASD) fined a broker \$150,000 because one of its customers bought Regulation S shares and sold them back in the United States through the broker's accounts before the end of their respective restricted periods.¹⁰³ The broker was fined for failing to make the required "affirmative determination" that they would not be within the restricted periods before executing the sales.¹⁰⁴

joined from engaging in future violations of the Securities and Exchange Act. *See id.* at 1060.

¹⁰⁰ The restricted period is generally 40 days for Category Two issuers and one year for Category Three issuers. *See* Original Regulation S, 17 C.F.R. §§ 230.903(c)(2)(iii), 230.903(c)(3)(iii)(A) (1990).

¹⁰¹ *See id.* § 230.903(c)(2)(iii); § 230.903(c)(3)(iii)(A).

¹⁰² *See* Gretchen Morgenson, *Foreign Stock Sales: Don't Get Blindsided*, WORTH, Mar. 1994, at 37. Given that securities offered under Regulation S are often sold at rewarding discounts to the prevailing market price, any immediate resale will usually guarantee rewarding profits. *See id.* at 38.

¹⁰³ *In re Alex. Brown & Sons, Inc.*, No. CMS 960084 AWC (NASD). The broker had executed 117 transactions for the customer that violated the regulation. *See id.* *See also* Brett D. Fromson, *Alex. Brown Broker Fined by NASD; Trading Involved Class of Stock Intended to be Sold Outside U.S.*, WASH. POST, Oct. 1, 1996, at C3; *Alex. Brown Fined \$100,000 for Regulation S Sales*, DERIVATIVES LITIG. REP., Oct. 14, 1996, at 9.

¹⁰⁴ *See* Deborah Lohse, *NASD Regulators Fine Alex. Brown*, WALL ST. J., Oct. 1, 1996, at C13. This sanction marked the first time the NASD's regulatory body, NASD Regulation Inc., has taken disciplinary action in connection with the sale of Regulation S securities. *See id.* Elisse B. Walter, the chief operating officer with NASD Regulation Inc. at the time,

2. *Creation and Use of Phony Offshore Shell Entities as a Means for Selling Unregistered Securities in the United States*

An abuse of Regulation S that has SEC enforcement and criminal implications is the formation and use of phony offshore shell entities as a means for an issuer or distributor to directly profit from the sale of unregistered securities in the United States. In this type of scheme, Regulation S is cited as the basis for selling securities to offshore shell entities formed by the issuer or distributor.¹⁰⁵ The offshore shell entities then hold onto the securities for the duration of the restricted period. At the end of the restricted period the offshore shell entities then sell the Regulation S shares into the United States with the proceeds from the sale making their way, directly or indirectly, to the issuer or distributor.¹⁰⁶ The SEC has found that such transactions do not qualify for the Regulation S safe harbors because they are nothing more than "sham offshore transactions" designed to evade the registration requirements of the Securities Act.¹⁰⁷

In *SEC v. Softpoint, Inc.*,¹⁰⁸ the SEC charged Softpoint Inc. (Softpoint) and its officers with, among other things, participating in a series of transactions selling unregistered Regulation S securities in the United States and disguising the proceeds as earnings from corporate sales.¹⁰⁹ To facilitate this complex scheme, the SEC alleged, Softpoint issued Regulation S securities to offshore distributors that it formed and/or controlled.¹¹⁰ Softpoint then directed the sale of these securities by the foreign distributors back into the United States.¹¹¹ Softpoint, in turn, received the proceeds from the

warned that "this settlement makes it clear that all NASD member firms are responsible for educating their staffs about the need to prevent abuses associated with Regulation S offerings." Bill Atkinson, *NASD Fines Alex. Brown over Rules Violation*, BALTIMORE SUN, Oct. 1, 1996, at C1. The NASD had no jurisdiction over the customer because the person was not a NASD member or a registered representative. See Fromson, *supra* note 103, at C3. See generally *Distribution by Broker-Dealers of Unregistered Securities*, Securities Act Release No. 33-4445, 27 Fed. Reg. 1415 (Feb. 2, 1962) (discussing the standards of conduct expected of broker-dealers in the distribution of unregistered securities).

¹⁰⁵ Problematic Practices Release, *supra* note 96, at 35,664.

¹⁰⁶ See *id.*

¹⁰⁷ See *id.* Therefore these transactions constitute violations of Section 5. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1994).

¹⁰⁸ *SEC v. Softpoint, Inc.*, SEC Litigation Release No. 14480, 59 SEC Docket 426 (S.D.N.Y. Apr. 27, 1995).

¹⁰⁹ See *id.* at 426.

¹¹⁰ See *id.* It was alleged that most, if not all, of these foreign entities were non-operating shell companies which were secretly formed, owned, and/or controlled by Softpoint's President and Chairman of the Board at the time. See *id.* See also *In the Matter of Donald J. Stoecklein*, Securities Act Release No. 7207, Exchange Act Release No. 36,177, 60 SEC Docket 327 (Sept. 1, 1995).

¹¹¹ See *Softpoint, Inc.*, 59 SEC Docket at 426.

sale and then falsely claimed them as earnings generated from product sales.¹¹²

In granting the SEC's Motion for Summary Judgment, the court presiding over the *Softpoint* case warned that Regulation S sheltered only *bona fide* overseas transactions.¹¹³ The court stated that Regulation S was not a "haven" for foreign stock distributions that were conducted as part of a plan to evade the registration requirements under the Securities Act.¹¹⁴ Accordingly, the court found that Softpoint was not engaged in bona fide overseas transactions and, therefore, did not fall under the safe harbor provisions under Regulation S.¹¹⁵

In *United States v. Sung*,¹¹⁶ a former chairman and chief executive of a corporation that established sham offshore shell entities as a means for profiting from the sale of Regulation S securities in the United States was convicted of securities fraud.¹¹⁷ This was the first criminal conviction related to a scheme involving Regulation S.¹¹⁸

In *Sung*, between January and March 1992, the chairman of Members Service Corporation (Members), Arthur Feher, Jr., had the corporation issue 1,411,000 shares of unregistered common stock pursuant to Regulation S under the names of a 95-year-old woman who lived with Feher and seven

¹¹² See *id.* Under the specific charges brought by the SEC in this case, Softpoint, Inc. ("Softpoint") disclosed in its reports that it had generated \$4.4 million in revenue from sales of its software to six foreign distributors in 1992 and 1993. See *id.* All of these sales were fictitious, and at least three of the six foreign distributors were formed and controlled by certain Softpoint officers. See *id.* Softpoint had issued 420,000 shares of stock under Regulation S to these foreign distributors, purportedly in exchange for "marketing rights." See *id.* The Softpoint officers then orchestrated the sale of most of the Regulation S stock through these foreign distributors and back into the United States without registering the sale. See *id.* The sale generated approximately \$1.72 million in proceeds, of which \$1.34 million were remitted to Softpoint. See *id.* Softpoint then applied these proceeds to the outstanding accounts receivables associated with the fictitious software sales of \$4.4 million and reported in its public filings and press releases that it was collecting on the outstanding accounts receivables due from the foreign distributors. See *id.*

¹¹³ See *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 861 (S.D.N.Y. 1997).

¹¹⁴ See *id.*

¹¹⁵ See *id.* In connection with the Softpoint scheme, an attorney settled with the SEC, agreeing to cease and desist from committing future violations of the securities laws and to pay disgorgement in the amount of \$19,975. See *In the Matter of Donald J. Stoecklein*, *supra* note 110, at 327. The attorney was the brother of one of the Softpoint officers. See *id.* An accountant was also sanctioned by the SEC in connection with his role in auditing public financial statements filed by Softpoint with the SEC. See *In the Matter of Duane V. Midgley, CPA*, Exchange Act Release No. 36,229, 60 SEC Docket 547 (Sept. 14, 1995). Without admitting or denying the Commission's findings, both the attorney and the accountant submitted offers of settlement which the Commission accepted. See *id.* at 547.

¹¹⁶ *United States v. Sung*, SEC Litigation Release No. 14901, 61 SEC Docket 2275 (M.D. Fla. May 6, 1996).

¹¹⁷ See *id.* at 2275.

¹¹⁸ See Jay Palmer, *First Time Loser: Executive Convicted of Fraud in Reg S Case*, BARRON'S, May 13, 1996, at 14.

Bahamian shell companies secretly established by Feher.¹¹⁹ Feher and his accomplices then manipulated the stock price upwards by issuing false press releases and misleading financial statements.¹²⁰ Once the stock price was high enough, Feher and his accomplices sold the stock into the United States market for approximately \$5.5 million.¹²¹ The outrageous circumstances underlying the *Sung* scheme attracted publicity concerning abuses of the regulation and generated increased criticism of the regulation's role in the marketplace.¹²² Nevertheless, violations using this type of scheme continue to occur.¹²³

¹¹⁹ See *Sung*, 61 SEC Docket at 2275. Feher listed the 95-year-old woman as a Canadian national and set up an address for her at a mail stop in Canada. See Al Lewis, *Predators Sniff out Loophole*, ROCKY MTN. NEWS, Oct. 21, 1996, at B1.

¹²⁰ See *Sung*, 61 SEC Docket at 2275. Feher manipulated the price of Members' common stock by substantially overstating corporate assets in SEC filings and by issuing false and misleading press releases concerning the Members' business operations. See *id.* These misleading press releases and financial statements led the stock price to rise from \$4 per share in March 1992 to approximately \$12 per share in June 1992. See *id.* See also Jaye Scholl, *Easy Money - How Foreign Investors Profit at the Expense of Americans*, BARRON'S, Apr. 29, 1996, at 31.

¹²¹ See *Sung*, 61 SEC Docket at 2275. The SEC recently filed a civil action for alleged securities violations associated with the scheme involved in this case. See *SEC v. Members Service Corporation*, SEC Litigation Release No. 15,371, 64 SEC Docket 1622 (D.D.C. May 22, 1997). See also David Baner, *B.C. Securities Firm Facing U.S. Civil Suit: SEC Alleges that Union Securities and a Former Employee Aided Stock Manipulators*, VANCOUVER SUN, Jul. 5, 1997, at B1. The SEC also instituted administrative proceedings against several accountants involved in the auditing of Members' financial statements during the time period relevant to the scheme in this case. See *In the Matter of Kenneth O'Neal, CPA*, Exchange Act Release No. 39,314, 65 SEC Docket 1866 (Nov. 7, 1997). Without admitting or denying the allegations, the accountants submitted offers of settlement to the Commission consenting to the issuance of an order denying them the privilege of appearing or practicing before the Commission as accountants for at least three years. See *id.* at 1866.

¹²² See generally Scholl, *supra* note 120, at 33-34; Danielle Herubin, *PSSSST! Wanna Buy Some Cheap Stock*, PALM BEACH POST, Jun. 1, 1997, at F1; and Gary Weiss, *The Mob on Wall Street*, BUS. WK., Dec. 16, 1996, at 92.

¹²³ The SEC recently filed a complaint alleging, among other things, that a former president of an issuer and others engaged in a fraudulent scheme to distribute shares purportedly issued under Regulation S to a fictitious foreign investor. See *SEC v. Marc A. Osheroff*, SEC Litigation Release No. 15,719, 66 SEC Docket 2531 (S.D. Fla. Apr. 23, 1998). It is alleged that within days or weeks after these shares were issued, most of these shares were deposited into U.S. brokerage accounts opened in the fictitious investor's name. See *id.* These shares were then allegedly sold at prevailing market prices. See *id.* The complaint filed by the Commission also alleges that a series of false press releases were issued to increase the price of the stock while the distribution was underway. See *id.* In another recent case, the SEC filed a complaint against several individuals alleging, among other things, that the former president and vice-president of a corporation were involved in a fraudulent scheme involving the "unregistered distribution" of the corporation's common stock "purportedly issued pursuant to Regulation S through foreign shell companies" controlled by the former president of the corporation. See *SEC v. Simon M. Rosenfeld*, SEC Litigation Release No. 15,274, 64 SEC Docket 80 (S.D.N.Y. Mar. 5, 1997).

3. *Use of Promissory Notes in Purchasing Regulation S Securities When the Expectation of Repayment Stems from the Resale of Securities in the United States*

Another abuse of Regulation S involves the use of promissory notes. In this type of scheme, a foreigner will purchase discounted Regulation S shares simply by signing a short-term, interest-free promissory note. The foreign holder, who in effect got the shares for nothing, will then wait out the restricted period (usually 40 days) and sell the shares into the U.S. market at the end of the restricted period.¹²⁴ The proceeds from this sale will then be used to pay off the promissory note and the foreigner will profit from the proceeds left over, usually the difference between the discounted purchase price and the prevailing market price at the time of the sale.¹²⁵ The SEC has considered such a use of promissory notes, for all or almost all of the purchase price where the expectation of repayment stems from the resale of securities into the U.S. market, as transactions in which the Regulation S securities never left the United States, as a matter of substance as opposed to form.¹²⁶

In the case of *In the Matter of Candie's, Inc.*,¹²⁷ the SEC instituted administrative proceedings against two issuers, a law firm, and the president of a brokerage firm, for alleged violations of the securities laws involving the use of promissory notes in the purchase of Regulation S securities.¹²⁸ In this case, two issuers sold stock under Regulation S through a New York law firm and brokerage firm to several foreign companies at substantial discounts to the prevailing market price in return for short-term, unsecured promissory notes due in 40 to 70 days.¹²⁹ These foreign companies then resold the stock in the United States through the New York brokerage firm once the restricted periods ended and used a portion of the proceeds from the sale of the stock to pay off the promissory notes.¹³⁰ The SEC found these offerings in reliance on Regulation S to constitute schemes to evade the registration requirements and therefore not offers and sales outside of the United States for purposes of Regulation S.¹³¹ The Commission stated

¹²⁴ Scholl, *supra* note 120, at 34.

¹²⁵ *See id.* In essence, the foreign purchaser receives a nice profit without having to put in any capital toward the purchase of Regulation S shares. *See id.*

¹²⁶ Problematic Practices Release, *supra* note 96, at 35,664.

¹²⁷ *See In the Matter of Candie's, Inc.*, Securities Act Release No. 7263, 61 SEC Docket 758 (Feb. 21, 1996). All four respondents submitted offers of settlement which the Commission accepted. *See id.* at 758. The respondents submitted these offers without admitting or denying the allegations by the Commission. *See id.*

¹²⁸ *See id.* at 759.

¹²⁹ *See id.*

¹³⁰ *See id.*

¹³¹ *Id.* at 761. The SEC noted that the investment risk in each transaction never shifted to the offshore purchaser. *See id.* The SEC also characterized this type of transaction as running afoul of Preliminary Note 2. *See id.* *See also* Original Regulation S, 17 C.F.R. Preliminary Note 2 (1990).

stated that, in essence, the foreign purchasers were acting as "mere conduits" for the sale of unregistered securities in the United States.¹³²

The *Candie's* case is unique in that for one of the first times under Regulation S the SEC found violations under the regulation where there was no apparent fraud or blatant violation of the regulation itself.¹³³ Rather the SEC looked at Preliminary Note 2 of Regulation S and interpreted the transactions involved in the *Candie's* case to constitute schemes designed to evade the registration requirements of the Securities Act.¹³⁴

4. *Use of the Resale Safe Harbor to "Wash Off" Restrictions from Otherwise Restricted Securities*

A problem uniquely associated with the resale safe harbor involves investors taking restricted securities that cannot be sold publicly in the United States and using the resale safe harbor as a means to engage in offshore transactions solely to wash off restrictions from these otherwise restricted securities.¹³⁵ In a release outlining problematic practices in the regulation (Problematic Practices Release), the SEC condemned this practice by expressly stating that the resale safe harbor could not be used for the purposes of washing off resale restrictions, such as the holding period requirement for restricted securities under Rule 144.¹³⁶ The SEC warned that when persons sell restricted securities in offshore transactions and replace them with repurchases of fungible unrestricted securities, that the replacement securities will be subject to the same restrictions as those replaced.¹³⁷

¹³² *Candie's*, 61 SEC Docket at 761.

¹³³ See Chris Gaudio, *SEC Sanctions Law Firm as Part of Reg S Settlement*, COMPLIANCE REPORTER, Mar. 4, 1996, at 1.

¹³⁴ *Candie's*, 61 SEC Docket at 761.

¹³⁵ Problematic Practices Release, *supra* note 96, at 35,664. The SEC noted that there was a practice in which investors were taking restricted stock that could not be sold in the United States offshore and "arranging sales solely in order to wash restrictions off the shares before bringing them back to the U.S." Cohen, *supra* note 3, at C1 (quoting former SEC Commissioner Richard Y. Roberts).

¹³⁶ See Problematic Practices Release, *supra* note 96, at 35,664; Rule 144, 17 C.F.R. § 230.144(d) (1997).

¹³⁷ See Problematic Practices Release, *supra* note 96, at 35,664. The Commission reiterated this position again in a no-action letter subsequent to the Problematic Practices Release when it stated that the resale safe harbor could not be used for the purposes of washing off resale restrictions. See *In Touch Global, LLC* [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,209, at 77,038-39 (Nov. 14, 1995). This letter dealt with the issue of whether restrictions on resales under Rule 502(d) of Regulation D would apply to resales of securities outside of the United States by persons other than the issuer, distributor or any of their affiliates. See *id.* at 77,037. The Commission warned that the resale safe harbor could not be used to wash off restrictions of otherwise restricted securities. See *id.* at 77,039. See also HAFT, *supra* note 44, at 2-12.

5. *Use of Hedging as a Means to Lock in Profits Associated with Discounted Purchases Under Regulation S*

Another abuse of Regulation S involves the practice of hedging or short selling. In this type of scheme, an offshore investor will purchase a set amount of Regulation S shares at a discount to the prevailing market price. The offshore investor will then immediately sell short the same amount of shares at the prevailing market price. In essence, the investor has locked in a profit of the difference between the prevailing market price versus the discounted purchase price for the Regulation S securities without having to incur any of the investment risks associated with waiting out the restricted period. When the offshore investor finally has to close out his short positions, he simply waits for the restricted period to end, sells the Regulation S shares back into the United States at the market price and then uses the proceeds to cover his short positions with purchases of the same amount of shares at the same market price (a wash).¹³⁸ The SEC has found this type of practice involving an investment fund to constitute violations of the securities laws in the case of *In the Matter of GFL Ultra Fund Ltd.*¹³⁹

In *GFL Ultra Fund*, the SEC instituted administrative proceedings against a British Virgin Islands corporation which had a fund (the "Fund") that had adopted a primary strategy of immediately short selling Regulation S shares purchased at a discount.¹⁴⁰ The strategy specifically involved "(i) purchasing for cash securities overseas which had been issued at substantial discounts and without registration pursuant to Regulation S; (ii) hedg-

¹³⁸ An example of how this works with numbers can be played out in the following simple scenario. Someone purchases one hundred shares of Regulation S securities, worth \$10/share at the prevailing market price, for the discounted price of \$7/share, a total investment of \$700. Then he immediately sells short one hundred shares at the \$10/share prevailing market price for \$1000. He thus locks in a profit of \$3/share or \$300. This is the same amount of profit he would have realized if he had sold his discounted shares for the prevailing market price immediately after he purchased them. However, in the short selling scenario, the investor still must unwind and cover his short positions by purchasing the number of shares that he sold short, or one hundred shares. To do this, the investor simply waits until the restricted period ends on his Regulation S shares. If the prevailing market price drops to \$8/share, he sells the hundred shares originally purchased through the Regulation S offering at the prevailing market price (\$8/share), then purchases the same number of shares at the prevailing market price (\$8/share) to cover his short positions for a wash. The investor thus loses nothing when he finally has to cover his short positions. Instead, he has hedged and secured the locked-in profits by short selling immediately after purchasing Regulation S shares, with none of the inherent risks associated with waiting out the restricted period.

¹³⁹ *In the Matter of GFL Ultra Fund Ltd.*, Administrative Proceeding Release No. 3-9333, 64 SEC Docket 1958 (June 18, 1997). GFL Ultra Fund Ltd. submitted an Offer of Settlement which the Commission accepted, consenting to entry of the SEC's findings and the imposition of a cease-and-desist order without admitting or denying the allegations by the Commission. See *id.* at 1958.

¹⁴⁰ See *id.* at 1958-59.

ing some or all of those securities through short selling in the United States before and/or during the 40 day restricted period under Regulation S . . . ; and (iii) unwinding the short positions, which involved covering the short positions using the Regulation S shares or selling the Regulation S shares in the open market in the United States after the 40 day restricted period had expired."¹⁴¹ The SEC noted that this "strategy resulted in a profit for the Fund when the Fund unwound its positions" and found that the Fund had virtually locked in its profits when it engaged in its short positions.¹⁴² The SEC specifically found the Fund to have violated Section 5 of the Securities Act by not registering "the Regulation S securities which it sold into the United States either by covering its short positions with the Regulation S shares or by directly selling the Regulation S shares (and purchasing freely-trading stock to cover the short positions)."¹⁴³ The SEC further surmised the covering of a short position to be the equivalent of a "sale" for purposes of the Section 5 registration requirements.¹⁴⁴

The Commission stated that there were no exemptions which the Fund could rely on to avoid the registration requirements.¹⁴⁵ The SEC specifically found that Section 4(1) which exempts "transactions by any person other than an issuer, underwriter, or dealer" did not apply in this case because the Fund was a "statutory underwriter" under Section 2(11) of the Securities Act.¹⁴⁶ The term "underwriter" under Section 2(11) is defined to include any person who has purchased securities from an issuer with a "view" towards the "distribution" of the securities.¹⁴⁷ The SEC stated that

¹⁴¹ *Id.* "The Fund participated in 90 Regulation S deals involving the common stock of 47 issuers and engaged in a short selling strategy with respect to some or all of the Regulation S shares purchased in 62 of these deals. The Fund generally purchased the Regulation S shares at a 15% to 20% discount to the prevailing market price." *Id.* at 1959.

¹⁴² *Id.* at 1959. In this case the SEC provided the following example of how the strategy operated in the Fund's case.

The Fund purchased 300,000 Regulation S shares from Zitel on December 12, 1994 at a discount of approximately 15% to the freely tradable share price. The Fund partially hedged these Regulation S shares by selling short 279,800 shares in five brokerage accounts between November 14, 1994, and January 19, 1995, in connection with this purchase of Regulation S shares. The Fund locked in a profit (the differential between the price at which the 279,800 shares were sold short net of commissions and the price at which the 279,800 Regulation S shares were purchased) of \$816,430.75. By February 7, 1995, the Fund had distributed all of its Zitel Regulation S shares into the United States markets and had closed out all of its Zitel short positions with purchases in the open market.

Id.

¹⁴³ *Id.* at 1960.

¹⁴⁴ *See id.*

¹⁴⁵ *See id.*

¹⁴⁶ *Id.* *See also* Securities Act of 1933 § 4(1), 15 U.S.C. § 77d(1) (1994); Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1994). The term underwriter means "any person who has purchased from an issuer with a view to, or offers and sells for an issuer in connection with, the distribution of any security . . ." Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1994).

¹⁴⁷ GFL Ultra Fund, 64 SEC Docket at 1960.

“when the Fund either covered its short positions with the unregistered Regulation S shares or sold the unregistered Regulation S shares directly into the United States markets (and purchased freely-trading shares to cover its short positions), the shares were ‘distributed’” within the meaning of the definition of an underwriter, because “substantial numbers of shares flowed into the trading markets.”¹⁴⁸ The SEC therefore reasoned that the Fund had purchased Regulation S shares with a view towards distribution, thus making it a statutory underwriter.¹⁴⁹ Because the Fund was considered an underwriter of the shares, rather than solely an investor in them, it was required to register the shares before reselling them and Section 4(1) could not apply as an exemption.¹⁵⁰

The Commission broadly stated in the *GFL Ultra Fund* case that a “trading pattern of short selling in the United States in connection with purchasing in a Regulation S offering, which essentially locks in a profit, . . . runs counter to the goals of Regulation S.”¹⁵¹ The SEC also expressed this position prior to the *GFL Ultra Fund* case in its Problematic Practices Release and in another release which proposed amendments to Regulation S (“Proposed Amendments Release”).¹⁵²

Former SEC Commissioner Steven Wallman, dissenting in the *GFL Ultra Fund* case, felt that there was too much confusion regarding the Commission’s views on hedging in securities offered under Regulation S at the time that the Fund had engaged in its hedging transactions.¹⁵³ He noted that the Fund had already ceased its trading strategy when the Commission espoused its formal views in the Problematic Practices Release and the Proposed Amendments Release, both of which expressed concerns about the use of hedging under the regulation.¹⁵⁴ Commissioner Wallman did not construe the Fund’s activities to be proper; however, given the lack of guidance by the Commission surrounding these types of trading activities, he felt that an “after the fact” enforcement action was not warranted in this case.¹⁵⁵

¹⁴⁸ *Id.* at 1961.

¹⁴⁹ *See id.* *See also* Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1994).

¹⁵⁰ *GFL Ultra Fund*, 64 SEC Docket at 1960; Securities Act of 1933 § 4(1), 15 U.S.C. § 77(d)(1) (1994). *See also* Floyd Norris, *SEC Orders Offshore Fund to Halt U.S. Stock Resale*, N.Y. TIMES, Jun. 19, 1997, at D20. Distributions by a statutory underwriter have to be registered under Section 5. *See United States v. Wolfson*, 405 F.2d 779, 782 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969). *See also* Problematic Practices Release, *supra* note 96, at 35664.

¹⁵¹ *GFL Ultra Fund*, 64 SEC Docket at 1961.

¹⁵² *See* Problematic Practices Release, *supra* note 96, at 35,664. *See also* Offshore Offers and Sales, Securities Act Release No. 33-7392, 62 Fed. Reg. 9258 (Feb. 28, 1997) [hereinafter Proposed Amendments Release].

¹⁵³ *GFL Ultra Fund*, 64 SEC Docket at 1961-62.

¹⁵⁴ *Id.*

¹⁵⁵ *Id.* at 1962-63. *See also* Norris, *supra* note 150, at D20; *GFL Ultra Fund Cited in Allegations by SEC on ‘Offshore’ Securities*, WALL ST. J., Jun. 19, 1997, at B16.

The question left open is whether an individual investor could also be held liable under the securities laws for hedging or short selling Regulation S securities. The *GFL Ultra Fund* case specifically found the Fund involved to be a statutory underwriter involved in short selling that could not claim an exemption under Section 4(1) which would generally exempt everyone except an issuer, underwriter or dealer.¹⁵⁶ An individual investor would appear to fall under Section 4(1). However, given the broad language in the *GFL Ultra Fund* case that a pattern of short selling in connection with a Regulation S offering "runs counter to the goals of Regulation S,"¹⁵⁷ an individual who engages in enough short selling transactions involving securities covered by Regulation S might be considered an underwriter, thus would not be exempt from registration. Therefore, the *GFL Ultra Fund* case might apply not only to investment companies or securities professionals but also to individual investors who engage in short selling transactions in connection with purchases of securities under Regulation S.

The *GFL Ultra Fund* case is unique in that, while technically the Commission found the Fund's actions to be those of a statutory underwriter subject to registration, the Commission's decision is so broad as to imply that hedging and short selling in connection with Regulation S may be impermissible altogether. This ruling met with criticism in the legal and securities communities. Former Commissioner of the SEC Edward H. Fleischman criticized the *GFL Ultra Fund* decision, stating that the SEC had deemed "hedging" to be illegal.¹⁵⁸ He attributed the SEC's "own ill regard of Regulation S" and "its traditional suspicion of short sales" as factors underlying the *GFL Ultra Fund* decision.¹⁵⁹ He also noted that consent orders, such as the one involved in the *GFL Ultra Fund* case, hold very little precedential weight in the courts.¹⁶⁰

Whether the SEC sought to declare hedging illegal is unknown. What is certain is that the form of hedging at issue in the *GFL Ultra Fund* case is another loophole in the regulation that the Commission never intended. The financial marketplace heard about this risk free type of trading activity which guaranteed profits (hedging through discounted Regulation S purchases) and utilized it as any other type of market instrument that ensures profits. The Commission did not like this unanticipated use of Regulation

¹⁵⁶ *GFL Ultra Fund*, 64 SEC Docket at 1960. See also Securities Act of 1933 § 4(1), 15 U.S.C. § 77(d)(1) (1994).

¹⁵⁷ *GFL Ultra Fund*, 64 SEC Docket at 1961.

¹⁵⁸ See Edward H. Fleischman, *A History Lesson for the SEC*, N.Y. TIMES, Jun. 29, 1997, § 3, at 14. Mr. Fleischman was one of the Commissioners who voted on Regulation S when it was adopted in 1990.

¹⁵⁹ See *id.*

¹⁶⁰ See *id.*

S and specifically addressed closing this loophole in its proposed amendments to Regulation S.¹⁶¹

The multitude of enforcement actions brought by the SEC for violations associated with Regulation S spawned bad publicity for the regulation as a qualified and efficient means of raising capital.¹⁶² This bad publicity intensified with increasing complaints about the regulation's harmful role in the domestic marketplace.

B. Concerns in the Marketplace about Regulation S

Aside from the regulatory problems associated with Regulation S, concerns have also arisen in the marketplace regarding the regulation's tendency to provide investment advantages to foreign investors. These concerns have little to do with the specific regulatory and enforcement problems mandating SEC attention but are important to note because they can often be attributed directly or indirectly to some of the abuses occurring in the regulation.

There are different attributes associated with securities offered under Regulation S which have produced a wave of domestic criticism about the role of the regulation in the marketplace. These attributes, which often reinforce each other, have led to complaints about the regulation for several important reasons.

1. *Discounted Shares Offered Solely to Foreigner Purchasers*

One of the most widespread complaints about Regulation S is that securities offered under the regulation are frequently sold to foreign purchasers at deep discounts to the prevailing market price.¹⁶³ Often, these shares can be bought for as low as 30 to 40 % below what American investors pay.¹⁶⁴ Foreigner purchasers enjoy this unique privilege simply because securities issued under Regulation S cannot be offered to United States investors.

Some companies offering attractive discounts understandably claim that such discounts are necessitated by the risks associated with having to

¹⁶¹ Proposed Amendments Release, *supra* note 152, at 9265.

¹⁶² For other civil actions filed by the SEC in connection with the improper use and/or abuse of Regulation S, see SEC v. Michael W. Rehtorik, SEC Litigation Release No. 13,975, 56 SEC Docket 368 (N.D. Tex. Feb. 23, 1994); SEC v. Environment Holdings, Inc., SEC Litigation Release No. 14,683, 63 SEC Docket 88 (N.D. Tex. Oct. 6, 1995); SEC v. Scorpion Technologies, Inc., SEC Litigation Release No. 14,814, 61 SEC Docket 749 (S.D.N.Y. Feb. 9, 1996); SEC v. Steven H. Schiffer, SEC Litigation Release No. 15,435, 65 SEC Docket 337 (S.D.N.Y. Aug. 7, 1997). Criminal charges involving a scheme relating to the sale of securities in reliance on Regulation S were also brought by the U.S. Attorney for the Eastern District of New York. See *United States v. Grant R. Curtis*, SEC Litigation Release No. 15,109, 62 SEC Docket 2799 (E.D.N.Y. Oct. 4, 1996).

¹⁶³ See Morgenson, *supra* note 102, at 37; Scholl, *supra* note 120, at 31.

¹⁶⁴ See Morgenson, *supra* note 102, at 37.

wait out the restricted periods.¹⁶⁵ Other companies offering such discounts simply do so because they may be too weak financially to raise money without slashing their share prices.¹⁶⁶ The Commission has conceded that some discounts may be warranted given the risks and circumstances associated with offerings under the regulation.¹⁶⁷ However, many American investors have perceived these discounts as providing an unfair market advantage to foreign investors.¹⁶⁸

2. *Lack of Disclosure*

Domestic investors have been historically unaware of Regulation S offerings because these offerings were hardly ever disclosed to the public.¹⁶⁹ It was not until the end of 1996 that the Commission finally required reporting issuers to report such offerings within fifteen days of occurrence.¹⁷⁰ Prior to this recent disclosure requirement domestic investors never knew when a Regulation S offering had taken place.¹⁷¹ To this day, shareholders of nonreporting issuers will still never know when an offering under the regulation has taken place. Without adequate disclosure often the first clue a domestic shareholder gets of a Regulation S offering is when there has been an unexplained drop in the company's share price.¹⁷² This drop usually occurs just after foreign shareholders have started dumping their shares back into the U.S. market or once the market has gotten wind of the Regu-

¹⁶⁵ *See id.*

¹⁶⁶ *See* Cohen, *supra* note 3, at C1; Scholl, *supra* note 120, at 33.

¹⁶⁷ *See* Problematic Practices Release, *supra* note 96, at 35,664 n.14. The Commission has stated that some discounts may be warranted "to compensate for the length of the restricted period, historic volatility of the stock, financial condition of the issuer, the dilution represented by the newly issued shares, current market condition, availability of current information as to the issuer, information the issuer may have had that was disclosed to the purchaser but not otherwise disclosed to the market, or other factors." *Id.* The Commission has warned, however, that discounts that are too unrelated to the "economics of the transaction" will run afoul of Regulation S. *Id.*

¹⁶⁸ *See* Morgenson, *supra* note 102, at 37. Many American investors have prided themselves as having the "fairest markets around." *Id.* Therefore questions have arisen as to why issuers can sell discounted Regulation S securities to foreigner purchasers that they cannot in turn sell to their existing domestic shareholders. *See id.*

¹⁶⁹ *See id.*; Scholl, *supra* note 120, at 31.

¹⁷⁰ *See* Periodic Reporting of Unregistered Equity Sales, Exchange Act Release No. 37801, 62 SEC Docket 2762, 2763 (Oct. 18, 1996) [hereinafter Form 8-K Reporting Release]. Domestic nonreporting companies are still not required to disclose offerings under Regulation S. Prior to November 1996, the only hard evidence of a Regulation S offering by a reporting issuer was when there was an increase in the issuer's shares outstanding. *See* Scholl, *supra* note 120, at 32. "But even then, there was no way of knowing on what terms the shares were issued." Floyd Norris, *The SEC is Set to Undo a Rule that was an Invitation to Abuse*, N.Y. TIMES, Oct. 9, 1996, at D8. Furthermore, this type of increase could only be seen in the issuer's quarterly reports, which often necessitated laser-like scrutiny to find such a Regulation S deal. *See* Scholl, *supra* note 120, at 32.

¹⁷¹ *See* Form 8-K Reporting Release, *supra* note 170, at 88,701.

¹⁷² *See* Scholl, *supra* note 120, at 32.

lation S offering.¹⁷³ By then it is often too late for the domestic shareholder to salvage the losses.¹⁷⁴ The harmful infusion of securities back into the U.S. market following the end of a restricted period is another market concern associated with the regulation.¹⁷⁵

3. Dilutive Effects Associated with the Flow of Regulation S Securities Back into the United States

When an issuer, through a Regulation S offering, increases its market capitalization by placing more of its shares in the marketplace, the value of each share shrinks. Under this concept, the existing shareholder of an issuer executing a Regulation S offering will have his shares diluted by such offering. This dilutive effect associated with the issuance of more outstanding shares is a common fact of life in the financial marketplace. However, the existing domestic shareholder of a company that has just completed a Regulation S offering can be at a disadvantage if he does not know that such an offering has taken place. When the domestic shareholder does find out, if he does at all, it is usually after foreigner purchasers have already sold their shares back into the United States and the stock price has dropped as a result of this influx of shares.¹⁷⁶

Taking into account the discount, lack of disclosure and dilutive market attributes of Regulation S all together, the following scenario illustrates how, prior to recent changes in the regulation, the domestic investor can be harmed by a Regulation S offering. An issuer will often do a Regulation S offering overseas at a discount to the prevailing market price, unbeknownst to its existing domestic shareholders. Once the 40 day or one year restricted period has expired, foreign purchasers, who will want to expectedly profit off of the discounted shares they have already purchased, will then immediately sell their shares back into the United States market. This infusion back into the United States of shares formerly held by foreigner purchasers will cause the financial marketplace to react to the dilutive effects of the incoming shares and the issuer's stock price to fall. The victims will

¹⁷³ See *id.* See also *infra* note 178 and accompanying text. Short-sellers are often attracted to Regulation S offerings as indications that a stock's price will go down due to the dilutive effect of such offerings or as signs of a company's weakening financial state. See *id.* Heavy short selling activity in a stock will often cause the stock price to fall. See *id.*

¹⁷⁴ See Scholl, *supra* note 120, at 32. There have also been complaints that existing shareholders should know when issuers are selling shares at large discounts because such discounts could be signs of the issuer's weakening financial state or that something odd is going on. See generally Norris, *supra* note 170, at D8; Morgenson, *supra* note 102, at 38. Healthy large companies rarely have to mark down their stock price to attract investors. See Morgenson, *supra* note 102.

¹⁷⁵ See Morgenson, *supra* note 102, at 37; Scholl, *supra* note 120, at 31.

¹⁷⁶ See Scholl, *supra* note 134, at 132.

be the issuer's existing domestic shareholders who will witness their shares' decline in value often without even knowing why.¹⁷⁷

The scenario above demonstrates how domestic investors can be harmed as a result of a Regulation S offering.¹⁷⁸ Despite these harmful market effects, everything in this scenario can be technically legal from an issuer's perspective. Companies can issue Regulation S shares at a discount (to a degree), refuse or minimally disclose Regulation S offerings, and allow the dilutive effects associated with Regulation S offerings occur unbeknownst to domestic investors. These factors, which compliment each other to make Regulation S offerings very attractive to foreigner investors, can be very harmful for domestic shareholders.

V. EVENTS LEADING UP TO AMENDMENTS IN REGULATION S

With the advent of the regulatory abuses and marketplace concerns in Regulation S, came criticism and scrutiny of the regulation and of those that abused it. First came cries from the financial community about the unfair attributes associated with offerings under Regulation S, then came increased enforcement initiatives by the SEC to mitigate damages caused by loopholes in the regulation. In the end, the regulation was amended to address all of these concerns. Tracing the evolution of events that eventually led to the amendments will help shed some light on why the regulation was rewritten the way it was and what it sought to address.

A. Developing Criticism of the Regulation

As early as 1994, the media began to catch on to some of the abusive practices surrounding the use of Regulation S.¹⁷⁹ At the same time, the SEC was showing signs that it did not like the way that the regulation was

¹⁷⁷ See Morgenson, *supra* note 102, at 38. In October 1996, the SEC required reporting issuers to report Regulation S offerings within fifteen days of occurrence. See Form 8-K Reporting Release, *supra* note 170. See also *infra* notes 191-94.

¹⁷⁸ Ironically, this practice has proven lucrative for some very unpopular players in the market: short-sellers. Short-sellers often hunt for Regulation S offerings with big discounts because they deem the company to be in financial trouble, or because they know that the dilutive effects associated with the flowback of Regulation S securities will kill the stock. See Gary Weiss, *The Secret World of Short-Sellers*, BUS. WK., Aug. 5, 1996, at 62. This sort of short selling activity is generally only associated with Regulation S offerings where the securities are offered at major discounts. See *id.* at 78-79. Short-sellers are recommended to specifically look for such Regulation S deals because they are great signs that the companies share price will go down. See Gary Weiss, *How to find a Stock That's Headed for Trouble*, BUS. WK., Dec. 30, 1996, at 118. The short sales by short-sellers themselves will also have the effect of driving down the issuer's share price. This type of short selling activity is not the type of short selling activity that has come under SEC scrutiny in the *GFL Ultra Fund* case. See generally *GFL Ultra Fund*, Administrative Proceeding Release No. 3-9333, 64 SEC Docket 1958 (June 18, 1997).

¹⁷⁹ See generally Morgenson, *supra* note 102, Cohen, *supra* note 3.

being misused.¹⁸⁰ These developments led U.S. Representative Edward Markey, Chairman of the House Energy and Commerce Telecommunications and Finance subcommittee to write the SEC in April 1994 and request a report to Congress as to whether the regulation should be repealed or substantially modified.¹⁸¹

The Chairman of the SEC, Arthur Levitt, responding to Representative Markey's letter several weeks later, confirmed that the Commission was aware of abuses of the regulation that were occurring.¹⁸² He advised that the Commission was in the process of determining "the most effective method to address" abuses in the regulation and indicated that the Commission's review could result in revision of the regulation itself or in increased enforcement initiatives targeted against abusers in the regulation.¹⁸³

¹⁸⁰ At the Practising Law Institute's annual "SEC Speaks" conference on March 5, 1994, Elisse Walter, then Deputy Director of the SEC's Division of Corporate Finance, indicated that misuse of the rules governing Regulation S had become a "very problematic area." *SEC's Walter Highlights Concern over Application of Regulation S*, 26 SEC. REG. & L. REP. (BNA) 366 (Mar. 11, 1994) (quoting Elisse Walter). Linda Quinn, Director of the SEC's Division of Corporate Finance, also cautioned that if people were "playing games" that the SEC was "going to find them" and take action. Karen Donovan, *SEC Officials Outline Agency's Agenda*, NAT'L L.J., Mar. 21, 1994, at B1 (quoting Linda Quinn). At a District of Columbia Bar gathering on March 8, 1994, Quinn again warned that the SEC had heard too many reports of people "pushing the envelope" of the Regulation S safe harbors and cautioned that the SEC would be "out and about looking at what's going on" in the Regulation S area. *Issuers' Pushing Envelope of Reg S Safe Harbor, Quinn Warns*, 26 SEC. REG. & L. REP. (BNA) 355-56 (Mar. 11, 1994) (quoting Linda Quinn). See also Samuel Wolff, *Recent Developments in International Securities Regulation*, 23 DENV. J. INT'L L. & POL'Y 347, 353 (1995).

¹⁸¹ See Letter from Rep. Edward Markey to SEC Chairman Arthur Levitt (Apr. 27, 1994) [hereinafter Markey Letter]. See also *Markey Seeks Report on Regulation S*, 26 SEC. REG. & L. REP. (BNA) 636 (Apr. 29, 1997); *Markey Calls on SEC to Review Regulation S*, CORP. FIN. WK., May 2, 1994, at 14. Representative Markey was the House lawmaker most closely involved with oversight of the securities industry at the time. *Markey Calls on SEC to Review Regulation S*, CORP. FIN. WK., May 2, 1994, at 14. In his letter to SEC Chairman Levitt, Representative Markey stated that he was "extremely concerned about indications of widespread abuses associated with Regulation S offerings." *Id.* (citing Markey Letter). He directed the SEC to examine whether some Regulation S sales were being done solely to evade the registration requirements and for an analysis on the incentives that Regulation S creates for foreign purchasers to drive down share prices in U.S. companies through short sales. See *id.*

¹⁸² Letter from SEC Chairman Arthur Levitt to Rep. Edward Markey (May 6, 1994) [hereinafter Levitt Response]. The Division of Enforcement and the Division of Corporation Finance were the two Divisions within the SEC that were involved in a coordinated review of offerings under Regulation S. See *id.* See also *SEC Staff Reviewing Best Way to Deal with Reg S Offshore Offering Problems*, 26 SEC. REG. & L. REP. (BNA) 696 (May 13, 1994); *Washington Roundup*, SEC. WK., May 16, 1994, at 4; *SEC Works on Way to Halt some Trading in Special Instances*, WALL ST. J., 1994 WL-WSJ 291861, May 18, 1994.

¹⁸³ Levitt Response, *supra* note 182. See also Wolff, *supra* note 180, at 354.

B. Problematic Practices Release

In June 1995 the Commission published its views on what it deemed to be abuses of Regulation S in an interpretive release entitled "Problematic Practices under Regulation S."¹⁸⁴ In this release, the Commission focused on Preliminary Note 2 of the regulation which stated that Regulation S was not available "with respect to any transaction or series of transactions that, although in technical compliance" with the regulation was "part of a plan or scheme to evade the registration provisions of the Act."¹⁸⁵ The Commission warned that there were circumstances which indicated that securities were being placed offshore temporarily to evade the registration requirements of the Act and noted that these types of transactions ran afoul of Preliminary Note 2.¹⁸⁶ Transactions specified by the Commission as being violative of the regulation included the illicit use of promissory notes and phony offshore shell entities, hedging activities involving purchases of Regulation S securities at large discounts, and the use of the resale safe harbor as a means for washing off restrictions from otherwise restricted securities.¹⁸⁷

The Commission requested comment on whether Regulation S should be amended and suggestions of ways to curb abuses in the regulation. One of the suggestions left for comment was a proposal to extend the 40 day restricted period to a full year and impose Category Three restrictions on Category Two securities.¹⁸⁸ It was also questioned whether there should be limits on the amount of discounts that could be offered.¹⁸⁹ Comment was further requested on whether restrictions should be implemented to prohibit hedging activities and the use of promissory notes in transactions involving securities issued under Regulation S.¹⁹⁰

C. Fifteen Day Reporting Requirement for Regulation S Offerings

Recognizing the dilutive effects and potential abuse problems that the lack of disclosure inherent under Regulation S offerings posed, in October 1996 the Commission adopted amendments to the Exchange Act periodic reporting forms and required domestic reporting issuers to disclose offer-

¹⁸⁴ Problematic Practices Release, *supra* note 96, at 35,663. Through this Release the Commission requested comments as to whether Regulation S should be amended to "limit its vulnerability to abuse." *Id.*

¹⁸⁵ *Id.* See also Original Regulation S, 17 C.F.R. Preliminary Note 2 (1990).

¹⁸⁶ See Problematic Practices Release, *supra* note 96, at 35,664. Such circumstances resulted when the ownership of the securities never left the U.S. market, a substantial portion of the economic risk was left in or returned to the U.S. market during the restricted period, or the transaction was such that "there was no reasonable expectation that the securities could be viewed as coming to rest abroad." *Id.*

¹⁸⁷ *Id.*

¹⁸⁸ See *id.* at 35,665.

¹⁸⁹ See *id.*

¹⁹⁰ See *id.*

ings made under the regulation.¹⁹¹ The SEC mandated that all Regulation S offerings by domestic reporting issuers be disclosed on a Form 8-K within fifteen days of the offering.¹⁹² With the adoption of this new reporting requirement Chairman Levitt declared that Regulation S was “one safe harbor with too many pirates in it.”¹⁹³ He also warned that the markets were “on notice” that he was “committed to addressing these abuses more directly,” but conceded that this recent action alone was “not a cure for what ails” Regulation S.¹⁹⁴

D. Proposed Amendments to Regulation S

In February 1997, the Commission published for comment proposed amendments to Regulation S.¹⁹⁵ In the proposals, the Commission recommended lengthening to two years the restricted period for domestic issuers and foreign issuers with a principal market in the United States.¹⁹⁶ The purpose of instituting this new two year restricted period was to align the

¹⁹¹ Form 8-K Reporting Release, *supra* note 170, at 2763. The revisions were designed “to address abusive practices in connection with the sale of equity securities by domestic companies in purported Regulation S offerings by requiring more disclosure about such sales in a timely fashion.” *Id.* The Commission stated that the “markets have been unaware of the potential dilution or the effects on the financial condition of the issuer” that Regulation S sales could cause. *Id.* The Commission also noted that the “lack of a specific disclosure requirement may be permitting” abusive practices by some U.S. issuers. *Id.*

¹⁹² *See id.* at 2764. The Commission required a current reporting under a Form 8-K within 15 days of a Regulation S sale, rather than quarterly reporting under a Form 10-Q, due to concerns that quarterly reporting would not be timely enough for Regulation S sales because, under the Regulation S 40 day restricted period for “sales of equity securities by domestic reporting companies, the restricted period could expire, and securities could be resold in the U.S. market before disclosure is made.” *Id.* The Commission acknowledged that it could later extend the restricted period for Category Two issuers in an Amended Regulation S and stated that “if the restricted period for sales of equity securities pursuant to Regulation S is changed, the Commission intends to consider revising the periodic disclosure requirement for Regulation S sales.” *Id.*

¹⁹³ Brett D. Fromson, *SEC tightens Overseas Sales Rules*, WASH. POST, Oct. 11, 1996, at F3 (quoting SEC Chairman Arthur Levitt).

¹⁹⁴ Mark H. Anderson, *SEC Changes Rule to Curtail Abuses of Offshore Offers*, WALL ST. J., Oct. 10, 1996, at C16 (quoting SEC Chairman Arthur Levitt). *See also SEC Places Limits on Offshore Offerings*, NAT’L L.J., Oct. 21, 1996, at B2.

¹⁹⁵ *See Proposed Amendments Release, supra* note 152. The Commission expressly stated that these proposals were “designed to stop abusive practices in connection with offerings of equity securities purportedly made in reliance on Regulation S.” *Id.* at 9258. The Commission’s primary area of concern was the use of Regulation S for sales of equity securities by domestic issuers. *Id.* at 9259.

¹⁹⁶ *See id.* at 9260. The Commission recommended lengthening the restricted period for Category Two domestic reporting issuers and foreign reporting issuers with a principal market in the United States for their securities from 40 days to two years. *See id.* It likewise proposed lengthening the restricted period for Category Three domestic nonreporting issuers and foreign nonreporting issuers with a principal market in the United States for their securities from one year to two years. *See id.*

Regulation S restricted periods with the Rule 144 holding periods.¹⁹⁷ The Commission also proposed imposing the certification, legending and other rigorous procedures applicable to securities under Category Three on all equity securities of domestic issuers and foreign issuers with a principal market in the United States for their securities.¹⁹⁸

To directly combat some of the regulatory problems associated with Regulation S, the Commission proposed an entirely new section to the regulation that would in effect classify equity securities of all domestic and foreign issuers with a principal market in the United States for their securities as restricted securities within the meaning of Rule 144.¹⁹⁹ The Commission further proposed prohibiting the use of promissory notes as payment for securities offered under Regulation S and to require that purchasers agree not to engage in hedging transactions in these securities.²⁰⁰

¹⁹⁷ See *id.* Rule 144 provides a safe harbor for the resale of restricted and control securities. See generally Rule 144, 17 C.F.R. § 230.144 (1997). This rule basically permits persons who hold such securities to publicly sell them without registration and without being deemed underwriters, if certain conditions are satisfied. *Id.* In a release contemporaneous with as the Proposed Amendments Release, the SEC amended the holding period requirements under Rule 144. See Revision of Holding Period Requirements in Rules 144 and 145, Securities Act Release 33-7390, 62 Fed. Reg. 9242 (Feb. 20, 1997). The Commission changed the holding period requirements "to permit the resale of limited amounts of restricted securities by any person after a one-year, rather than two-year holding period." *Id.* at 9243. The amendments also permitted "unlimited resales of restricted securities held by non-affiliates of the issuer after a holding period of two years, rather than three years." *Id.*

¹⁹⁸ See Proposed Amendments Release, *supra* note 152, at 9260-62.

¹⁹⁹ See *id.* at 9263. The Commission proposed to make it clear in the Regulation that offshore resales under the resale safe harbor of equity securities that would be newly defined as restricted securities within the meaning of Rule 144 would not affect the restricted status of such securities. See *id.* at 9265. The Commission was seeking to make it understood in the regulation that the resale safe harbor could not be used to wash off restrictions from otherwise restricted securities. *Id.* The Commission proposed providing such a notice under a new Rule 905. See *id.* Amendments to Rule 144(a)(3) would also be undertaken to classify these securities as restricted securities within the meaning of Rule 144. See *id.* Rule 144(a)(3) specifically defines the term restricted securities under Rule 144. Rule 144, 17 C.F.R. § 230.144(a)(3) (1997). Another release issued simultaneously with the Proposed Amendments Release noted that the types of securities issued under Regulation S could be included within the definition of restricted securities under Rule 144. Revision of Rule 144, Rule 145 and Form 144, Securities Act Release 33-7391, 62 Fed. Reg. 9246, 9249 (Feb. 20, 1997). This release proposing further revisions to Rule 144 accompanied the release adopting final rules to Rule 144. See generally Revision of Holding Period Requirements in Rules 144 and 145, *supra* note 197.

²⁰⁰ See Proposed Amendments Release, *supra* note 152, at 9262-63, 9265 (concerning promissory notes and hedging). For purposes of clarification, the Commission likewise proposed generally to edit the language within the regulation to make it more concise and understandable. See *id.* at 9266. These technical and clarifying revisions included: 1) revising the captions of the three sections in the issuer safe harbor under Rule 903 to specifically refer them to their commonly known terminology as "Category 1," "Category 2," and "Category 3"; 2) revising the issuer safe harbor to state clearly for each category what procedures are to be followed for each category; 3) combining or moving some of the definitions within Rule 902 into the Rule 903 safe harbor category to make the rule easier to read

The proposals were greeted with mixed reaction. The Commission publicly expressed its hopes that an amended Regulation S would curb abuses associated with the regulation. Chairman Levitt announced that the Commission had launched a “regulatory armada that should drive most of the marauders out” of the Regulation S safe harbor.²⁰¹ However, many commentators to the proposals did not express like enthusiasm. While commending the Commission’s efforts in seeking a solution to the ongoing abuses of Regulation S, many commentators felt that the measures proposed were excessively restrictive and would significantly impair the ability of issuers to raise capital under Regulation S.²⁰² This view was shared by others on Wall Street as well as in the domestic and international legal securities arena.²⁰³ Some even felt that the SEC was wrongly reacting to what many had perceived as marketplace advantages that the regulation had created for foreigner investors, rather than to regulatory abuses stemming from violations of the regulation itself.²⁰⁴

and understand; and 4) generally editing the language in the rule to make it more understandable. *See id.*

²⁰¹ *SEC Proposes to Tighten Safe Harbor Under Reg S for Offshore Offerings*, 29 SEC. REG. & L. REP. (BNA) No. 8, at 218 (Feb. 21, 1997) (quoting SEC Chairman Arthur Levitt).

²⁰² *See* Comments of Gary J. Wolfe, Seward & Kissel, New York, Apr. 29, 1997; Comments of John T. Bostelman, Daniel Dunson, Charles F. Rechlin, Mary C. Moynihan, and David B. Rockwell, Sullivan & Cromwell, New York, Apr. 29, 1997; Comments of Richard E. Gutman, Chairman, Committee on Securities Regulation of the Business Law Section of the New York State Bar Association, Albany, N.Y., Apr. 29, 1997; and Comments of Joseph McLaughlin, Brown & Wood LLP, New York, May 30, 1997, U.S. Securities Exchange Commission, *SEC Proposed Rules*, (visited Aug. 25, 1997) <<http://www.sec.gov/rules/propridx.htm>>.

²⁰³ *See* Larry Light, *Expat Stock May Get Homesick*, BUS. WK., Jul. 14, 1997, at 4. The SEC’s proposal for increasing the waiting period to two years set off a “roar of protest from Wall Street” because of “fears that such a long period would dampen enthusiasm for Regulation S stocks abroad.” *Id.* Also, other countries objected to the newer restrictive proposals being applied to foreign issuers. *See SIA Lobbies Against SEC Stance on Reg S Proposal*, GLOBAL COMPLIANCE REPORTER, Jun. 2, 1997, at 2. The proposals were deemed to create a disincentive for foreign issuers to list on the U.S. markets. *See id.*

²⁰⁴ Sara Hanks & Richard Cohn, *The Wrong Weapon and the Wrong Target: The SEC’s Recent Proposed Changes to Regulation S*, INSIGHTS, Aug. 1997, at 23. Sara Hanks, one of the authors of the original Regulation S, believed that the potential damage that could result from the proposals far outweighed any benefit sought by the SEC in stopping the abusive practices occurring under the regulation. *See id.* She noted that many U.S. investors perceived that they were being treated worse than foreign investors were, and that the media had criticized Regulation S because of these concerns in the marketplace. *See id.* She felt that it appears to be the “differential treatment for U.S. versus foreign investors that the Commission [was] reacting to” in setting more stringent requirements under the proposals. *Id.*

VI. AMENDMENTS TO REGULATION S

On February 10, 1998, the Commission adopted amendments to Regulation S which became effective on April 27, 1998.²⁰⁵ The SEC passed the amendments on the same day it brought forth proposed rules designed to prevent fraud in the area of micro-cap stocks.²⁰⁶ In doing so, it apparently took the opportunity to publicize the amendments as part of its efforts to crack down on micro-cap stock fraud.²⁰⁷

In the release accompanying the amendments, the Commission emphasized that the amendments were "designed to stop the abusive practices in connection with offerings of equity securities purportedly made in reliance on Regulation S."²⁰⁸ It noted that most abuses occurring in the regulation concerned equity securities of domestic issuers.²⁰⁹ In this regard, the most drastic changes to the regulation can be seen in those areas that apply to domestic issuers.

The most important change to the regulation by the amendments was a reclassification of domestic reporting equity securities to the third issuer safe harbor category.²¹⁰ Another important change by the amendments was

²⁰⁵ See Amending Release, *supra* note 4; Amended Regulation S, 17 C.F.R. §§ 230.901-230.905 (1998).

²⁰⁶ See Registration on Securities on Form S-8, Securities Act Release No. 33-7506, 66 SEC Docket 1069 (Feb. 17, 1998) (proposing amendments to Form S-8 to restrict use of the form for the sale of securities to consultants and advisors, and to allow use of the form for the exercise of stock options by family members of employee optionees); Publication or Submission of Quotations Without Specified Information, Exchange Act Release No. 34-39670, 66 SEC Docket 1091 (Feb. 17, 1998) (proposing amendments to Rule 15c2-11 to enhance certain informational requirements for quotations and generally require broker-dealers to review information about the issuer when they publish a quotation).

²⁰⁷ See Floyd Norris, *The SEC Proposes Anti-Fraud Rules for 'Micro-cap' Stocks*, N.Y. TIMES, Feb. 11, 1998, at D8; Tom Lowry, *SEC Tightens Restrictions on Offshore Stock Issues*, USA TODAY, Feb. 11, 1998, at B3. The combining of the new amendments as part of the Commission's micro-cap stock fraud initiatives was somewhat odd, since the Commission's efforts to curb abuses associated with the regulation generally have been separate and apart from any distinct program to stop micro-cap stock fraud. While it is conceivable that most of the fraud involving securities offered under Regulation S has been associated in one way or another with thinly capitalized companies, the Commission announced the amendments as a means to fix an ongoing micro-cap stock fraud problem that has become a pressing issue recently. The amendments to Regulation S are more a product of the ongoing abuses in the regulation which have been the subject of scrutiny by Congress and the media. See *supra* Part V for a history of events leading to amendments in the regulation.

²⁰⁸ Amending Release, *supra* note 4, at 9632.

²⁰⁹ See *id.* at 9632-33.

²¹⁰ See Amended Regulation S, 17 C.F.R. § 230.903(b)(3) (1998); Amending Release, *supra* note 4, at 9634-35. Equity securities of domestic reporting issuers no longer have the benefit of the shorter 40 day restricted period, but now must be held for at least a full year before they can be resold in the United States. Amended Regulation S, 17 C.F.R. § 230.903(b)(3)(iii)(B)(1) (1998). These securities also have to meet the stringent certification, legending and other transactional requirements that were previously only applicable to Category Three nonreporting companies. *Id.* § 230.903(b)(3)(iii)(B); Amending Release, *supra* note 4, at 9635-36.

the implementation of a new rule that now effectively categorizes equity securities of domestic issuers, reporting and nonreporting, as restricted securities within the meaning of Rule 144.²¹¹ Foreign issuers did not suffer the same fate as domestic reporting issuers. In the proposed amendments to the regulation, the Commission considered imposing Category Three restrictions and the restricted securities classification to foreign issuers with a “principal market” in the United States for their securities.²¹² The Commission decided not to impose these additional restrictions in the amendments because of a lack of abuse in this area of the regulation.²¹³

The amendments took various approaches to tackle some of the abuses of Regulation S. In going through the regulation as amended, it is important to focus on what relevant changes, if any, were made to the regulation from its originally adopted form.

A. General Statement Not Affected by Amendments

There were no changes to the General Statement as it was originally written under Rule 901.²¹⁴ The General Statement continues to provide that offers and sales of securities outside the United States meeting the requirements of Regulation S are not subject to the registration requirements under Section 5 of the Securities Act.²¹⁵ The General Statement can continue to be used as a basis alone for determining whether the registration provisions of the Securities Act would apply or the provisions of the issuer and resale safe harbors can continue to be followed to meet within the confines of the General Statement. Therefore, while the wording of the General Statement has not been changed literally by the amendments, the requirements needed to meet the General Statement have been somewhat modified through amendments to the issuer and resale safe harbors.

B. Amendments to the Issuer and Resale Safe Harbors

The amendments shifted the classification of securities that fall under the different issuer safe harbor categories. Several provisions were added that changed or modified some of the requirements necessary for qualifying under the safe harbors. The most dramatic change can be seen in the areas of the regulation covering the securities of domestic reporting issuers.

²¹¹ See Amended Regulation S, 17 C.F.R. § 230.905 (1998); Amending Release, *supra* note 4, at 9636.

²¹² See Proposed Amendments Release, *supra* note 152, at 9260-63. See also *supra* notes 196-99 and accompanying text.

²¹³ See Amending Release, *supra* note 4, at 9633; Proposed Amendments Release, *supra* note 152, at 9260-63. However, the Commission did warn that it would still “monitor practices in this area” and “revisit the issue” should abuses occur. Amending Release, *supra* note 4, at 9633.

²¹⁴ See Amended Regulation S, 17 C.F.R. § 230.901 (1998).

²¹⁵ See *id.* For a more detailed analysis and definition of the General Statement, see *supra* notes 27-30 and accompanying text.

1. *Amendments to the Two General Conditions of an Offshore Transaction and No Directed Selling Efforts in the United States*

The two general conditions that there be both an offshore transaction and no directed selling efforts in the United States continue to apply to both the issuer and resale safe harbors.²¹⁶ However, the definitions underlying these two conditions have undergone some minor changes from their original form.

An offer or sale must still be made in an offshore transaction to qualify for the issuer and resale safe harbors.²¹⁷ The definition of an "offshore transaction" has not been changed substantively in any way by the amendments.²¹⁸ However, the definition of a "designated offshore securities market" for purposes of qualifying for the offshore transaction requirement has been amended to reflect and include those exchanges that were later named as designated offshore securities markets after the original regulation was adopted.²¹⁹

The requirements for the issuer and resale safe harbors still mandate that no directed selling efforts be made in the United States by an issuer, distributor and any of their respective affiliates or agents.²²⁰ The definitions underlying the meaning of directed selling efforts have generally remained the same but have been modified within the regulation itself to make them more concise.²²¹ Directed selling efforts are still those activities

²¹⁶ Amended Regulation S, 17 C.F.R. §§ 230.903(a)(1)-(2), 230.904(a)(1)-(2) (1998).

²¹⁷ *Id.* §§ 230.903(a)(1), 230.904(a)(1).

²¹⁸ *Id.* § 230.902(h). An offer or sale of securities is still deemed to have occurred in an offshore transaction if the offer is not made to a person in the United States and either (1) the buyer is outside the United States at the time the buy order is originated or the seller (and any person acting on its behalf) reasonably believes that the buyer is outside the United States or (2)(a) for purposes of the issuer safe harbor, the transaction is executed in, on or through a physical trading floor of a foreign securities exchange or (b) for purposes of the resale safe harbor, the transaction is executed in, on or through the facilities of a designated offshore securities market. *See id.*

²¹⁹ *Id.* § 230.902(b). *See supra* note 41 and accompanying text for a detailed explanation and definition of a designated offshore securities market. The additional exchanges that have been added to the definition of a designated offshore securities market include the Alberta Stock Exchange, the Bermuda Stock Exchange, the Copenhagen Stock Exchange, the European Association of Securities Dealers Automated Quotation (the European equivalent to NASDAQ, recently included in the definition), the Helsinki Stock Exchange, the Irish Stock Exchange, the Istanbul Stock Exchange, the Mexican Stock Exchange, the Oslo Stock Exchange, the Stock Exchange of Singapore Ltd., and the Warsaw Stock Exchange. *See* Amended Regulation S, 17 C.F.R. § 230.902(b) (1998). These exchanges were designated by the SEC's Division of Corporation Finance as designated offshore securities markets through a series of interpretive letters. *See supra* note 41 and accompanying text.

²²⁰ Amended Regulation S, 17 C.F.R. §§ 230.903(a)(2), 230.904(a)(2).

²²¹ *Id.* § 230.902(c). *See also supra* notes 42-44 and accompanying text for a general analysis of the meaning of directed selling efforts. The definition of directed selling efforts under Rule 902(c) was amended to make it more clear and concise. *See* Amended Regulation S, 17 C.F.R. § 230.902(c). The new Rule 902(c) takes the old Rule 902(b) definition of directed selling efforts and the old Rule 902(k) definition for a "publication with a general

that have the effect of conditioning the market in the United States for securities being offered and sold in reliance on Regulation S.²²²

2. Amendments to the Issuer Safe Harbor

Equity securities of domestic reporting issuers were moved into the third issuer safe harbor category while equity securities of foreign reporting issuers with a substantial market interest in the United States retained their Category Two status.²²³ The issuer safe harbor categories were also made more concise and understandable through the amendments.²²⁴

(a) Changes to Category One

The first issuer safe harbor category was generally unaffected by the amendments.²²⁵ It still applies to the securities of foreign issuers with “no substantial U.S. market interest” for their securities,²²⁶ securities offered

circulation in the United States” and combines the two to make the definition of directed selling efforts more understandable. *Id.* The new Rule 902(c) also delineates in better fashion what activities do not constitute directed selling efforts for purposes of the regulation. *Id.* § 230.902(c)(3). Added to this list of activities which would not constitute directed selling efforts not contained in the original section covering directed selling efforts is a provision exempting notices of certain proposed offerings under section 230.135 and certain proposed unregistered offerings under section 230.135c. *Id.* § 230.902(c)(3)(vi). Also included in this list of activities not constituting directed selling efforts is a provision governing access by journalists to offshore press conferences, meetings and/or written press materials in which a present or proposed offering of securities is discussed and the requirements of section 230.135e are satisfied. *Id.* § 230.902(c)(3)(vii). In October 1997, the Commission adopted Rule 135e of the Securities Act which provided a safe harbor for offshore press activities conducted in connection with an offering by a foreign private issuer or a foreign government issuer. *See* Offshore Press Conferences, Meetings with Company Representatives Conducted Offshore and Press-Related Materials Released Offshore, 17 C.F.R. § 230.135e, Securities Act Release No. 33-7470, 62 Fed. Reg. 53948 (Oct. 17, 1997). Activities meeting the requirements of this safe harbor would not, among other things, constitute directed selling efforts within the meaning of Regulation S. *Id.* at 53950. The old Rule 902(b) definition of directed selling efforts was amended to reflect this new safe harbor and the substance of these amendments are now contained in the current definition under Rule 902(c). *See id.*; Amended Regulation S, 17 C.F.R. § 230.902(c)(3)(vii) (1998).

²²² *See* Amended Regulation S, 17 C.F.R. § 230.902(c) (1998).

²²³ *See id.* at § 230.903(b)(2)-(3).

²²⁴ *See* Amending Release, *supra* note 4, at 9638. The captions for the three issuer safe harbor categories have now been labeled “Category 1,” “Category 2” and “Category 3.” *Id.*; Amended Regulation S, 17 C.F.R. § 230.903(b)(1)-(3). Some of the definitions in the Rule 902 definitional section of the regulation were also literally moved into the Rule 903 issuer safe harbor categories to make these categories more understandable. *See* Amending Release, *supra* note 4, at 9638.

²²⁵ *See* Amended Regulation S, 17 C.F.R. § 230.903(b)(1) (1998).

²²⁶ *Id.* § 230.903(b)(1)(i). The definition of “substantial U.S. market interest” has remained relatively the same as the old Rule 902(n) and is now defined in Rule 902(j). *See id.* § 230.902(j). For a discussion of the definition of “substantial U.S. market interest,” see *supra* note 54 and accompanying text.

and sold in "overseas directed offerings,"²²⁷ securities backed by the full faith and credit of a foreign government,²²⁸ and securities offered and sold pursuant to certain employee benefit plans established and administered in accordance with the laws of a foreign country.²²⁹ Offers and sales of securities under this category only have to meet the two general conditions of an offshore transaction and no directed selling efforts in the United States.²³⁰

While the definitional and categorical aspects of Category One have not been changed by the amendments, a particular class of securities covered under this category has been affected. Category One equity securities of domestic issuers sold to foreign resident employees pursuant to employee benefit plans governed by foreign law are now classified as restricted securities within the meaning of Rule 144.²³¹ Therefore, they are subject to the restrictions associated with being classified as restricted securities, including a one year holding period before the securities can be resold into the United States.²³² Prior to the amendments these type of securities were not subject to any kind of restrictions or limitations other than those specified under Category One.²³³

²²⁷ Amended Regulation S, 17 C.F.R. § 230.903(b)(1)(ii) (1998). The definition of an "overseas directed offering" has basically remained the same as the definition in the old Rule 902(j). For discussion of the definition of "overseas directed offering" see *supra* note 55 and accompanying text. The definition formerly under Rule 902(j) of what constitutes an "overseas directed offering" is now contained within the section governing Category One for clarity purposes. Amended Regulation S, 17 C.F.R. § 230.903(b)(1)(ii) (1998).

²²⁸ See *id.* § 230.903(b)(1)(iii).

²²⁹ See *id.* § 230.903(b)(1)(iv). For a discussion of when securities offered to employees pursuant to an "employee benefit plan" established and administered in accordance with the laws of a foreign country will fall under the first issuer safe harbor category, see *supra* note 57 and accompanying text.

²³⁰ See *id.* § 230.903(b)(1).

²³¹ See *id.* § 230.905; Amending Release, *supra* note 4, at 9634. Regulation S now contains a new Rule 905 which in effect treats equity securities of domestic issuers as restricted securities within the meaning of Rule 144. See Amended Regulation S, 17 C.F.R. § 230.905; Rule 144, 17 C.F.R. § 230.144 (1997). All securities under this restricted securities status are subject to, among other things, a one year holding period. See § 230.144. See also *infra* notes 278-93 and accompanying text for a detailed discussion and analysis of Rule 905.

²³² See Amended Regulation S, 17 C.F.R. § 230.905 (1998); Amending Release, *supra* note 4, at 9634. The Commission noted that several commentors to the Commission's proposed amendments to Regulation S felt that it was inappropriate to require foreign resident employees to accept restricted securities pursuant to their employee benefit plans. See *id.* However, since Rule 905 was to extend to all equity securities of domestic issuers, it determined to apply Rule 905 to these types of securities. See *id.* The Commission advised that if reporting domestic issuers wished to give their foreign resident employees "immediate access" to the U.S. markets to sell such securities, that the Form S-8 is an available method to permit such issuers to register these types of securities on a streamlined basis. See *id.*

²³³ See Original Regulation S, 17 C.F.R. § 230.903(c)(1)(iv) (1990). See also Amending Release, *supra* note 4, at 9634.

(b) Changes to Category Two

There has been a transition in the type of securities covered under Category Two.²³⁴ Securities covered under this category now include the securities of foreign reporting issuers with a substantial market interest in the United States for their securities, debt securities of reporting issuers, and debt securities of nonreporting foreign issuers.²³⁵ Category Two no longer covers equity securities of domestic reporting issuers which are now covered under the third issuer safe harbor category.²³⁶ This class of securities was the hardest hit by the amendments and, in the end, may have become a casualty of the regulation's abuses.

While there has been a shift in the class of securities covered under Category Two, the requirements under this category have generally remained the same with a few minor exceptions. Securities covered under Category Two are still required to meet the two general conditions of an offshore transaction and no directed selling efforts in the United States.²³⁷ They must also continue to meet a set of transactional and offering restrictions.²³⁸

The transactional restrictions under Category Two have remained the same, except for a change in terminology; this change should not, however, produce any confusion. Securities covered under Category Two continue to be subject to a 40 day restricted period wherein the securities cannot be offered or sold to or for the benefit of a U.S. person.²³⁹ Distributors selling securities to certain securities professionals during this restricted period must continue to send confirmation or other notice to the purchaser stating that the purchaser is subject to the same restrictions on offers and sales that applied to the selling distributor.²⁴⁰ The term "restricted period" as used in the transactional requirements, and in the original regulation in general to describe the holding period applicable to the Regulation S safe harbors, has now been changed to the term "distribution compliance period."²⁴¹ "Distribution compliance period" does not mean anything different from the pre-

²³⁴ See Amended Regulation S, 17 C.F.R. § 230.903(b)(2) (1998).

²³⁵ See *id.*

²³⁶ See *id.* § 230.903(b)(2)-(3). See also Original Regulation S, 17 C.F.R. § 230.903(c)(2) (1990). Thus domestic reporting issuers no longer enjoy the benefits of a shorter, 40 day holding period and the less stringent transactional restrictions that are associated with securities covered under Category Two. See Amended Regulation S, 17 C.F.R. § 230.903(b)(2)(ii)-(iii).

²³⁷ See *id.* § 230.903(a).

²³⁸ See *id.* § 230.903(b)(2).

²³⁹ See *id.* § 230.903(b)(2)(ii).

²⁴⁰ See *id.* § 230.903(b)(2)(iii).

²⁴¹ See *id.* The new definition of "distribution compliance period" is substantially the same as the definition of "restricted period" in the original Regulation S. See Amended Regulation S, 17 C.F.R. § 230.902(f) (1998) (defining "distribution compliance period"); Original Regulation S, 17 C.F.R. § 230.902(m) (1990) (defining "restricted period"). See also *supra* note 65 and accompanying text.

viously used "restricted period," but was simply a means to distinguish "distribution compliance period" from the term "restricted securities" now applicable to domestic equity securities offered under Regulation S.²⁴²

As applied to securities covered under Category Two, the offering restrictions governing these securities have not changed.²⁴³ Distributors must still agree in writing that all offers and sales made prior to the end of a distribution compliance period be conducted in compliance with the rules governing Regulation S.²⁴⁴ All offering materials used in connection with the sale of Regulation S securities during the distribution compliance period must also continue to include statements that the securities have not been registered and may not be sold in the United States or to U.S. persons absent registration or an exemption.²⁴⁵

(c) Changes to Category Three

Category Three continues to be the third residual safe harbor category and applies to all equity and debt securities not covered under Categories One and Two.²⁴⁶ Category Three now includes the equity securities of domestic reporting issuers, domestic nonreporting issuers and foreign nonreporting issuers with a substantial market interest in the United States for their securities.²⁴⁷

The procedures for Category Three continue to be the most rigorous in the issuer safe harbor categories because of the greater likelihood of these securities flowing back into the United States.²⁴⁸ Securities under this

²⁴² See Amending Release, *supra* note 4, at 9635. New Rule 905 now categorizes equity securities of domestic issuers as restricted securities within the meaning of Rule 144. See Amended Regulation S, 17 C.F.R. § 230.905 (1998). See also *infra* notes 281-84 and accompanying text. The Commission changed the term restricted period to distribution compliance period to avoid confusion between the requirements applicable under the issuer safe harbors from those applicable under Rule 144. See Amending Release, *supra* note 4, at 9635. The Commission felt that changing the holding period under Regulation S to the term "distribution compliance period" would clarify that the availability of the issuer safe harbor has "no bearing on whether purchasers of Regulation S securities may be acting as statutory underwriters if they purchase with a view to reselling into the U.S. markets." See *id.*

²⁴³ See Amended Regulation S, 17 C.F.R. §§ 230.902(g), 230.903(b)(2)(i) (1998). *But see infra* notes 266-71 and accompanying text (discussing how the offering restrictions have changed as applied to Category Three securities of domestic issuers to address prohibitions on hedging.)

²⁴⁴ See Amended Regulation S, 17 C.F.R. § 230.902(g)(1) (1998).

²⁴⁵ See *id.* § 230.902(g)(2). Such statements are required to appear on the cover or inside page of a prospectus or offering circular used in connection with the sale. See *id.* § 230.902(g)(2)(i). They must also appear in the underwriting section of any prospectus or offering circular in connection with the sale. See *id.* § 230.902(g)(2)(ii). They must further appear in any advertisement made or issued by an issuer, distributor or any of their respective affiliates or agents. See *id.* § 230.902(g)(2)(iii).

²⁴⁶ See *id.* § 230.903(b)(3).

²⁴⁷ See *id.*

²⁴⁸ See Amending Release, *supra* note 4, at 9635.

category must continue to meet the two general conditions of an offshore transaction and no directed selling efforts in the United States.²⁴⁹ They are also required to meet a stringent set of transactional and offering restrictions that have been modified from their original form.²⁵⁰

The transactional restrictions under Category Three are divided between debt and equity securities.²⁵¹ The transactional restrictions for debt securities are less stringent than those for equity securities and have not changed from the original regulation.²⁵² Debt securities continue to be governed by a 40 day distribution compliance period.²⁵³ They also have to be represented upon issuance by a "temporary global security which is not exchangeable for definitive securities" until expiration of this 40 day period and, for persons other than distributors, until "certification of beneficial ownership of the securities by a non-U.S. person" or of a U.S. person who purchased the securities in a transaction exempt from registration.²⁵⁴

The transactional requirements as applied to Category Three equity securities continue to be the most comprehensive in the regulation.²⁵⁵ Category Three equity securities are still subject to a one year restricted or distribution compliance period.²⁵⁶ Within this distribution compliance period, purchasers, other than distributors, must certify that they are not U.S. persons and are not acquiring the securities for the account or benefit of a U.S. person.²⁵⁷ Purchasers must also continue to agree to resell these securities only in accordance with the rules under Regulation S, registration or under any other exemption.²⁵⁸ However, under this purchasing agreement restriction, the amendments have added a new requirement that all purchasers agree additionally not to engage in hedging transactions with respect to these securities "unless in compliance with the Act."²⁵⁹

Other Category Three transactional restrictions require that a legend be placed on the securities of Category Three domestic issuers stating that transfers in these securities are prohibited except in accordance with the provisions governing the regulation.²⁶⁰ With the amendments this legend must now also contain a provision within it stating that hedging in these se-

²⁴⁹ See Amended Regulation S, 17 C.F.R. § 230.903(a) (1998).

²⁵⁰ See *id.* §§ 230.902(g), 230.903(b)(3).

²⁵¹ See *id.* § 230.903(b)(3)(ii)-(iii).

²⁵² See *id.* § 230.903(b)(3)(ii). See also *supra* note 77 and accompanying text.

²⁵³ See *id.* § 230.903(b)(3)(ii)(A).

²⁵⁴ *Id.* § 230.903(b)(3)(ii)(B).

²⁵⁵ See *id.* § 230.903(b)(3)(iii)-(iv).

²⁵⁶ See *id.* § 230.903(b)(3)(iii)(A). The transactional restrictions must be followed if an offer or sale of the securities offered under Regulation S is to take place prior to the end of the one year distribution compliance period. See *id.* § 230.903(b)(3)(iii)(B).

²⁵⁷ See *id.* § 230.903(b)(3)(iii)(B)(1).

²⁵⁸ See *id.* § 230.903(b)(3)(iii)(B)(2).

²⁵⁹ *Id.*

²⁶⁰ See *id.* § 230.903(b)(3)(iii)(B)(3).

curities may not be conducted "unless in compliance with the Act."²⁶¹ The issuer, either by contract, provision in its bylaws or other comparable document, must also be bound to refuse to register any transfer of securities not made in compliance with the rules governing Regulation S.²⁶² Distributors selling Category Three equity or debt securities prior to the expiration of the distribution compliance period must continue to provide notice to these purchasers that each purchaser is subject to the same restrictions as those that applied to the selling distributor.²⁶³

The amendments basically changed the transactional restrictions in the third issuer safe harbor category to require that purchasing agreements and legends contained on the securities now include statements prohibiting hedging activities within the distribution compliance period unless in compliance with the Act.²⁶⁴ These changes seem to evince the Commission's way of ensuring that those acquiring Category Three securities are put on notice that some forms of hedging in these securities are forbidden. They also seem to show the Commission's position against hedging as noted in the *GFL Ultra Fund* case, and may be an attempt by the Commission to address any concerns of the public's lack of awareness of such prohibitions that were the subject of former Commissioner Wallman's dissent in that case.²⁶⁵

There were amendments to the offering restrictions applicable to domestic equity securities under Category Three which, like the amendments to the transactional restrictions, concerned prohibitions on hedging.²⁶⁶ Under the first offering restriction for equity securities covered under Category Three, distributors are still required to agree in writing that all offers and sales made prior to the expiration of the distribution compliance period be made in compliance with the regulation.²⁶⁷ Distributors are now also required, with respect to equity securities of domestic issuers, to agree in writing not to engage in hedging transactions with these securities prior to the expiration of the distribution compliance period "unless in compliance with the Act."²⁶⁸ The second offering restriction continues to require that

²⁶¹ *Id.*

²⁶² *See id.* § 230.903(b)(3)(iii)(B)(4).

²⁶³ *See id.* § 230.903(b)(3)(iv).

²⁶⁴ *See id.* § 230.903(b)(3)(iii)(B)(2)-(3).

²⁶⁵ *See GFL Ultra Fund*, 64 SEC Docket at 1961-63. *See also supra* notes 153-55 and accompanying text. It is important to note that, given the uncertainty of the *GFL Ultra Fund* case and the Commission's conflicting statements regarding hedging in Regulation S, the public will probably still be unaware of what prohibitions exist against hedging. *See infra* notes 340-54 and accompanying text.

²⁶⁶ *See Amended Regulation S*, 17 C.F.R. §§ 230.902(g), 230.903(b)(3)(i) (1998). For debt securities covered under Category Three, the offering restrictions are essentially the same as those that govern Category Two, including the applicability of a 40 day distribution compliance period. *See id.* *See also supra* notes 243-45 and accompanying text.

²⁶⁷ *See Amended Regulation S*, 17 C.F.R. § 230.902(g)(1)(i) (1998).

²⁶⁸ *Id.* § 230.902(g)(1)(ii).

all offering materials and documents used in connection with the offer and sale of Category Three securities contain statements that the securities have not been registered and may not be offered or sold in the United States or to U.S. persons.²⁶⁹ The amendments now likewise require, with respect to equity securities of domestic issuers, that these offering materials state that hedging transactions in these securities are prohibited “unless in compliance with the Act.”²⁷⁰ The two changes in the offering restrictions as applied to the equity securities of domestic issuers reflect the Commission’s intention on providing notice to anyone involved in these type of securities that certain kinds of hedging activities are not allowed under the regulation.²⁷¹

(d) Changes to the Resale Safe Harbor and New Rule 905

There were no literal changes to the resale safe harbor. However, a newly adopted Rule 905 effectively changed the scope of how the resale safe harbor is to be applied within the regulation.²⁷² Domestic equity securities offered under Regulation S are also now classified as restricted securities within the meaning of Rule 144.²⁷³

(i) Changes to the Resale Safe Harbor

The resale safe harbor has changed very little in substance.²⁷⁴ Rule 904 continues to provide a safe harbor for the offshore resale of unregistered securities by any persons other than the issuer, distributor, or any of their respective affiliates or agents.²⁷⁵ To be eligible for the resale safe harbor, the two general conditions of an offshore transaction and no directed selling efforts in the United States have to be met as well as several additional conditions pertaining to dealers and certain affiliates, as applicable.²⁷⁶ While the resale safe harbor has substantively remained the same,

²⁶⁹ See *id.* § 230.902(g)(2).

²⁷⁰ *Id.* These statements must appear in the same areas within the materials as required under Category Two. See *supra* note 245 and accompanying text.

²⁷¹ See Amended Regulation S, 17 C.F.R. §§ 230.902(g)(1)(ii), 230.902(g)(2). It is important to note that the new amended anti-hedging provisions in the Category Three transactional and offering restrictions reflect that hedging activities involving these securities are not to take place “unless in compliance with the Act.” *Id.* §§ 230.902(g)(1)(ii), 230.902(g)(2), 230.903(b)(3)(iii)(B)(2)-(3). It can be presumed that any hedging activities associated with such securities which occur within the one year distribution compliance period could be deemed not to be “in compliance with the Act” in light of the *GFL Ultra Fund* case. See *id.* See also *supra* notes 138-52 and accompanying text.

²⁷² See Amended Regulation S, 17 C.F.R. §§ 230.904, 230.905 (1998).

²⁷³ See *id.* § 230.905.

²⁷⁴ See *id.* § 230.904.

²⁷⁵ See *id.* § 230.904(a).

²⁷⁶ See *id.* § 230.904(a)(1)-(3). Securities professionals are subject to two additional conditions to qualify for the resale safe harbor. See *id.* § 230.904(b)(1). Prior to the end of a relevant distribution compliance period, dealers or any persons receiving selling conces-

the rules governing the effect of resales of domestic securities under this safe harbor have been modified by Rule 905.²⁷⁷

(ii) New Rule 905

The Commission added new Rule 905 to Regulation S and entitled it "Resale Limitations."²⁷⁸ This rule now provides a restricted securities classification to domestic equity securities and prohibits the use of the resale safe harbor as a means to wash off restrictions from such restricted securities.²⁷⁹ Indirectly through Rule 144, Rule 905 also attempts to remedy the problems associated with the misuse of promissory notes in the regulation.²⁸⁰

(a) *Domestic Equity Securities now Classified as Restricted Securities Within the Meaning of Rule 144*

The Commission amended Regulation S and added Rule 905 to "clarify the legal obligations of purchasers" in securities offered under Regulation S.²⁸¹ In doing so, the Commission promulgated Rule 905 and simultaneously amended Rule 144 to classify domestic equity securities of both reporting and nonreporting issuers as restricted securities.²⁸² Rule 905

sions for the securities sold must not know that the buyer of such securities is a U.S. person. *See id.* § 230.904(b)(1)(i). If such a dealer or other person receiving selling concessions with respect to the securities sold knows that the purchaser is likewise a dealer or a person receiving a selling concession in connection with the offer or sale, the dealer acting on the seller's behalf must send to the purchaser notice that the securities may be sold during the distribution compliance period only in accordance with the rules governing Regulation S. *See id.* § 230.904(b)(1)(ii). An officer or director of an issuer or distributor is eligible to rely on the resale safe harbor if the sole reason such officer or director may be deemed an affiliate is by virtue of position and no special compensation is paid in connection with the offer and sale by such officer or director. *See id.* § 230.904(b)(2).

²⁷⁷ *See id.* § 230.905.

²⁷⁸ *Id.*

²⁷⁹ *Id.*

²⁸⁰ *See id.*

²⁸¹ Amending Release, *supra* note 4, at 9636. New Rule 905, entitled "Resale Limitations," states:

Equity securities of domestic issuers acquired from the issuer, a distributor, or any of their respective affiliates in a transaction subject to the conditions of § 230.901 or § 230.903 are deemed to be "restricted securities" as defined in § 230.144. Resales of any such restricted securities by the offshore purchaser must be made in accordance with this Regulation S (§ 230.901 through § 230.905, and Preliminary Notes), the registration requirements of the Act or an exemption therefrom. Any "restricted securities," as defined in § 230.144, that are equity securities of a domestic issuer will continue to be deemed to be restricted securities, notwithstanding that they were acquired in a resale transaction made pursuant to § 230.901 or § 230.904.

Amended Regulation S, 17 C.F.R. § 230.905 (1998).

²⁸² *See* Amending Release, *supra* note 4, at 9636, and Amended Regulation S, 17 C.F.R. § 230.905. *See also* Rule 144, 17 C.F.R. § 230.144(a)(3)(v) (1997). Rule 144(a)(3), which defines the term "restricted securities," now has a section that includes "[e]quity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions"

of Regulation S specifically provides that equity securities of domestic issuers acquired in an offer or sale subject to Regulation S will be deemed restricted securities within the meaning of Rule 144.²⁸³ This new restricted securities classification means that equity securities of domestic issuers are now subject to the requirements of Rule 144, including a one year holding period before they can be resold.²⁸⁴

(b) *Resales of Domestic Equity Securities not Eliminating the Restricted Securities Classification*

Rule 905 now prevents investors from using the resale safe harbor as a means to wash off restrictions from restricted securities offered under Regulation S and falling within the definition of Rule 144 generally.²⁸⁵ Rule 905 specifically provides that restricted securities as defined under Rule 144 “will continue to be deemed” restricted securities “notwithstanding that they were acquired in a resale transaction” pursuant to the resale safe harbor.²⁸⁶ These new provisions are a major step beyond the cautionary statements made by the Commission prior to the amendments being adopted.²⁸⁷

(c) *The Effect of Rule 905 on Promissory Notes*

By deeming domestic equity securities as restricted securities within the meaning of Rule 144, the Commission prohibited the use of promissory notes in the purchase of Regulation S securities where the expectation of repayment for the promissory notes stemmed from the resale of Regulation

of the General Statement or issuer safe harbor categories under Regulation S. Rule 144, § 230.144(a)(3)(v). In this regard, Rule 905 appears to have added Rule 144 as an available resale exemption for securities offered under Regulation S. *See* Amended Regulation S, 17 C.F.R. § 230.905.

²⁸³ *See* Amended Regulation S, 17 C.F.R. § 230.905.

²⁸⁴ *See* Rule 144, 17 C.F.R. § 230.144(d)(1) (1997). While this one year holding period might seem irrelevant because a one year distribution compliance period already exists for Category Three domestic equity securities, the requirement serves as an additional measure to ensure that these securities will not be resold to any persons in the United States for at least a year and is relevant in tolling the holding period for purchases in Regulation S through the use of promissory notes. *See id.*

²⁸⁵ Amended Regulation S, 17 C.F.R. § 230.905 (1998).

²⁸⁶ *Id.* In the adopting release accompanying the amendments the Commission noted that “Rule 905 clarifies that the resale of restricted securities offshore under Rule 904 does not wash off the restricted status of those securities to allow them to be freely resold into the United States by the purchaser.” Amending Release, *supra* note 4, at 9637.

²⁸⁷ *See* Amended Regulation S, 17 C.F.R. § 230.905 (1998); Problematic Practices Release, *supra* note 96, at 35,664; In Touch Global LLC (Nov. 14, 1995), *supra* note 137 at 77,038-39. *See also supra* notes 136-37 and accompanying text for a discussion of the cautionary statements made by the Commission regarding the resale safe harbor being used to wash off restrictions.

S securities back into the United States.²⁸⁸ Now that Rule 144 is applied to domestic equity securities, when purchasing Regulation S securities through the use of promissory notes, the one year holding period under Rule 144 is tolled until certain conditions are satisfied.²⁸⁹ The one year holding period will not begin to run for purchasers unless the promissory note (1) "provides full recourse against the purchaser of the securities;" and (2) "is secured by collateral, other than the securities purchased, having a fair market value at least equal to the purchase price of the securities purchased."²⁹⁰ Furthermore, after the holding period requirement has been satisfied, the promissory note must be paid in full before there can be a resale of the securities under Rule 144.²⁹¹ The Commission noted that this provision "ensures that the funds obtained through the Rule 144 resale will not be used to pay off the promissory note."²⁹² Therefore, foreign purchasers can no longer purchase securities under Regulation S with promissory notes and then later directly pay off such promissory notes with proceeds from reselling the Regulation S securities back into the United States.²⁹³

C. Other Changes Through the Amendments

The amendments imposed a quarterly reporting requirement on Regulation S offerings by domestic issuers.²⁹⁴ They also addressed recent concerns about abuses in the area of convertible securities.²⁹⁵

²⁸⁸ See Amended Regulation S, 17 C.F.R. § 230.905 (1998). See also *supra* notes 124-34 and accompanying text.

²⁸⁹ See Rule 144, 17 C.F.R. § 230.144(d)(2) (1997).

²⁹⁰ *Id.* § 230.144(d)(2)(i)(ii).

²⁹¹ See *id.* § 230.144(d)(2)(iii); Amending Release, *supra* note 4, at 9637.

²⁹² Amending Release, *supra* note 4, at 9637. It is important to note that in the proposals to amend Regulation S, the Commission proposed to prohibit the use of promissory notes altogether as a form of payment for Regulation S securities. See Proposed Amendments Release, *supra* note 152, at 9262-63; Amending Release, at 9637. However, the Commission felt that the tolling approach under Rule 144 would address the promissory note problem since securities purchased under Regulation S would be fully paid before the securities could be resold in the United States under Rule 144. See Amending Release, at 9637. The Commission noted that in this case "the resale of the securities in the U.S. markets under Rule 144 would not be used to raise funds to repay the promissory note." See Amending Release, at 9637. The Commission also explained that under the approach adopted, promissory notes can still be accepted as payment for the purchase of Regulation S equity securities by domestic companies. See Amending Release, at 9637.

²⁹³ But see *infra* notes 370-71 for a discussion on how a lender could still be used as a middleman to indirectly pay off promissory notes with proceeds from the resale of Regulation S securities back into the United States.

²⁹⁴ See Amending Release, *supra* note 4, at 9638.

²⁹⁵ See Amending Release, *supra* note 4, at 9634. See also Jaye Scholl, *Pirates' Play?*, BARRON'S, Jan. 7, 1997, at 17.

1. Reporting of Regulation S Transactions

The change in the distribution compliance period from 40 days to one year for domestic issuers lessened the need for such issuers to report the sale of Regulation S securities within fifteen days of an offering.²⁹⁶ Therefore, the amendments eliminated the fifteen day Form 8-K reporting requirement and substituted a quarterly reporting requirement.²⁹⁷ This new quarterly reporting requirement will be effective January 1, 1999, and the Form 8-K requirement should be followed until then.²⁹⁸

2. Convertible Securities

The amendments addressed a troubling area involving Regulation S and convertible securities.²⁹⁹ Typically with convertible securities, investors will buy convertible bonds expecting to receive interest payments while waiting for the stock price to increase.³⁰⁰ These investors will then usually convert their convertible bonds after the stock price has risen above an agreed-upon conversion price.³⁰¹ A type of Regulation S convertible debenture which works very differently than the ordinary convertible bond has resulted in problems under the regulation. This type of convertible debenture has a conversion price that is typically set by taking the average price of the stock over five days leading up to the conversion date.³⁰² In addition, the issuer will include an extra discount from the final conversion price.³⁰³ With this type of convertible debenture, the lower the price of the stock, the better the deal for the convertible debenture investor.³⁰⁴

²⁹⁶ See *supra* notes 190-94 and accompanying text. Arguably, the market still needs to know almost immediately about any substantial offerings under the regulation because news of such an offering can sometimes have an adverse effect on the issuer's stock price. See *supra* note 178 and accompanying text.

²⁹⁷ Amending Release, *supra* note 4, at 9638. The Commission did not see it necessary to mandate that domestic issuers report their Regulation S offerings within 15 days of occurrence in light of the fact that these securities cannot be sold back in the United States for at least one year. See *id.*

²⁹⁸ See *id.* Forms 10-Q, 10-QSB, 10K or 10KSB can be used, as applicable, to fulfill this quarterly reporting requirement. See *id.* The Commission delayed the effectiveness of the new quarterly reporting requirements so that it could "monitor closely developments under the amended safe harbor procedures during a transition period." *Id.* The exception to this delayed effectiveness rule is that, to the extent that the sales qualify for Category One treatment under the issuer safe harbor categories, a domestic issuer's sale of Regulation S securities to its non-U.S. resident employees pursuant to an employee benefit plan only has to be reported by the issuer on an aggregated basis with Form 10-Q, rather than with Form 8-K, prior to January 1, 1999. See *id.*

²⁹⁹ See Amending Release, *supra* note 4, at 9634.

³⁰⁰ See Scholl, *supra* note 295.

³⁰¹ See *id.*

³⁰² See *id.*

³⁰³ See *id.*

³⁰⁴ See *id.*

For some companies engaging in transactions with this type of Regulation S convertible debenture, share prices had a "mysterious habit of dipping" just before the debentures were converted.³⁰⁵ The decrease in share price gave offshore debenture holders great bargains when converting their convertible debentures and led to increased suspicions about the use of Regulation S convertible debentures in the marketplace.³⁰⁶ As a result, several companies have suspended or refused to honor conversion rights on these type of convertible securities.³⁰⁷ Some companies have claimed that investors were part of an effort to drive down the share price, through short selling or otherwise, and to convert their debentures at bargain prices.³⁰⁸ Other companies did not have the sufficient number of authorized shares to issue upon conversion as a result of the ratcheting-up effect of the discounted conversion price.³⁰⁹

These problems led the Commission to address directly the use of convertible securities under Regulation S in the amendments.³¹⁰ In addressing the convertible securities problem, the Commission stated that the new restrictions and the restricted securities classification applicable to domestic equity securities would also apply to convertible securities.³¹¹ The Commission reasoned that convertible securities, including convertible debt securities, met the definition of "equity securities" and therefore would be subject to the new restrictions.³¹² The Commission further noted

³⁰⁵ *See id.*

³⁰⁶ *See id.* An example of this can be seen in the company of Chantal Pharmaceutical. *See id.* On October 30, 1996, this company raised \$5.2 million in a Regulation S convertible deal. *See id.* The terms called for conversion of one third of the debentures into common stock shares 45 days later, on December 14. *See id.* The price set in October was to be the lesser of \$3.91 a share or 80% of the average closing price five days immediately preceding the conversion date. *See id.* "Chantal's stock sank to new lows in the days leading up to the conversion, averaging 1 7/8 a share between December 9 and 13." *Id.* With the 20% discount, the December conversion appears to have resulted in an additional 1.1 million shares outstanding. *See id.*

³⁰⁷ *See id.* *See also* Richard H. Rowe, *An Overview of Certain Registration Provisions, Exemptions and Developments Under the U.S. Securities Law Governing Capital Formation*, 1035 *PLI/Corp* 89, 158 (1998).

³⁰⁸ *See* Scholl, *supra* note 295. One issuer even stated that it intended to honor conversions only for those investors whose trading records proved that they were not part of an organized effort to drive down the issuer's stock price in the days before the conversion. *See id.*

³⁰⁹ *See* Rowe, *supra* note 307, at 158; Scholl, *supra* note 295. Under the terms of these deals, the number of shares obtained at conversion increases as share prices decline. *See* Weiss, *supra* note 178, at 118.

³¹⁰ *See* Amending Release, *supra* note 4, at 9634.

³¹¹ *See id.*

³¹² *Id.* The Commission reasoned that Rule 405 of Regulation C defines the term equity security to include securities convertible or exchangeable into stock. *See id.* *See also* Rule 405 Definitions of terms, 17 C.F.R. § 230.405 (1997).

that abuses involving the use of convertible securities made it necessary to apply the new restrictions to this type of securities.³¹³

VII. PROBABLE IMPACT OF AMENDMENTS ON REGULATION S

The amendments were designed specifically to address abusive practices occurring under the regulation.³¹⁴ The amendments, intentionally or unintentionally, also addressed some of the marketplace concerns with the regulation. Whether or not the amendments will effectively control or eliminate these problems, only time will tell. While no one can predict the future, a close reading of the amendments in light of ongoing abuses of the regulation might provide some guidance as to how the amendments will impact present regulatory and marketplace concerns.

A. Probable Effect of the Amendments on the Cost of Raising Capital under Regulation S

The amendments will probably raise the cost that domestic reporting issuers will have to incur in raising capital under Regulation S. These new costs will accrue as a direct consequence of the new legending, certification, record keeping and overall monitoring burdens that domestic reporting issuers will now have to face.³¹⁵

The extension of the holding period for equity securities of domestic reporting issuers will also affect the price at which these securities will be offered by domestic issuers. The extension of the holding period to one year will probably necessitate domestic reporting issuers offering greater discounts on their securities than they did before the amendments.³¹⁶ These discounts will be even more warranted given that these securities will be labeled restricted securities and contain legends stating that the transfer of

³¹³ See Amending Release, *supra* note 4, at 9634. The Commission cited Jaye Scholl's article, *see supra* note 295, as a reference for abuses in the use of convertible securities under Regulation S. *See id.*

³¹⁴ See Amending Release, *supra* note 4, at 9632.

³¹⁵ See Amended Regulation S, 17 C.F.R. § 230.903(b)(3) (1998). Even the Commission has conceded that the new restrictions may make it more costly for domestic issuers to raise capital through Regulation S. *See* Amending Release, *supra* note 4, at 9639. However, the Commission has categorized this potential increase in costs as "negligible." *Id.* Commission staff conducted an informal survey of attorneys in private practice whose clients could be expected to rely on Regulation S. *See id.* From the survey, the Commission found that domestic issuers selling equity securities under the regulation already complied with the Category Three certification and legending requirements "as a matter of common practice." *See id.* Therefore based on the survey the Commission felt that "[n]o new costs will be imposed on domestic issuers as a result of formally extending the Category Three requirements to sales of equity securities by domestic issuers." *Id.*

³¹⁶ *See* Morgenson, *supra* note 102, at 37; Problematic Practices Release, *supra* note 96, at 35664. The larger discount will reflect the longer period offshore purchasers will have to hold onto their securities before reselling them in the United States and thus the inherent risks associated with waiting out the holding period. *See* Morgenson, *supra* note 102, at 37.

these securities is prohibited.³¹⁷ These greater discounts will in turn force domestic reporting issuers to sell higher quantities of securities to raise the same amount of capital that they were able to raise prior to the amendments. If such issuers are set on selling a fixed number of shares, then the greater discounts will lead these issuers to raise less capital than they were able to raise prior to the amendments.

Taking into account the higher cost of conducting a Regulation S offering along with the probable decrease in the amount of capital that can be raised, the amendments may deter domestic reporting issuers from raising capital under Regulation S. Such issuers may be inclined to simply register their securities or pursue other exemptions from registration rather than incur the costs and inherent burdens associated with raising capital under the regulation.³¹⁸

The amendments should have little or no economic impact on domestic nonreporting issuers and foreign issuers. Domestic nonreporting issuers have always been subject to the Category Three requirements and therefore the amendments should not create any additional costs for these issuers.³¹⁹ Foreign issuers escaped the brunt of the amendments and therefore should also not have to face any additional costs as a result of the amendments.

³¹⁷ See Amended Regulation S, 17 C.F.R. §§ 230.903(iii)(B)(3), 230.905 (1998).

³¹⁸ In the release accompanying the amendments, the Commission advised that "domestic reporting companies that find it too cumbersome to take advantage of the Regulation S safe harbor" when conducting an offering could "simply register under the Securities Act or resort to other exempt offerings." See Amending Release, *supra* note 4, at 9636. It is important to note that the probable higher costs imposed on domestic reporting issuers appeared to contradict the intent of the Commission when it first adopted Regulation S in 1990 and made the cost of raising capital overseas less expensive and more accessible to domestic corporations. See *supra* pp. 58-59, 61 and notes 3 and 19.

³¹⁹ See Original Regulation S, 17 C.F.R. § 230.903(c)(3) (1990). The securities of domestic nonreporting issuers are subject to the new anti-hedging provisions. See Amended Regulation S, 17 C.F.R. §§ 230.902(g), 230.903(b)(3)(iii)(B)(2)-(3) (1998). However, the only additional costs on issuers associated with these provisions are the costs for adding an additional sentence with respect to hedging on the issuer's legend, offering materials and purchasing agreements. See Amended Regulation S, 17 C.F.R. §§ 230.902(g), 230.903(b)(3)(iii)(B)(2)-(3) (1998). A survey of private practitioners conducted by Commission staff found these increased costs with respect to hedging to be insignificant. See Amending Release, *supra* note 4, at 9639. However, domestic nonreporting issuers may have to offer greater discounts to compete with domestic reporting issuers in the future. The securities of domestic reporting and nonreporting issuers are now subject to the same restrictions; but the securities of reporting issuers can more easily be resold in the marketplace. Therefore, domestic nonreporting issuers may have to offer greater discounts to entice buyers who might otherwise be more inclined to purchase the same securities from domestic reporting issuers. In this capacity, the amendments may have an indirect economic impact on domestic nonreporting issuers. See *infra* notes 358-59 and accompanying text.

B. Probable Impact of Amendments on Regulatory Abuses

The amendments to Regulation S were specifically enacted to address the regulatory problems associated with the regulation.³²⁰ Whether or not the amendments effectively closed the loopholes that enabled abuses to occur remains to be seen.

The abuses associated with the use of promissory notes and the resale safe harbor to wash off restrictions from otherwise restricted securities appears to have been addressed by the amendments. The Commission used a formula that essentially mixes rules underlying Regulation S with those governing Rule 144. The amendments also seem to indicate that hedging is prohibited through changes made to the offering and transactional requirements as applied to domestic issuers, yet nothing in the amendments or the regulation itself seem to define this prohibition on hedging. The abuses involving illegal resales within the distribution compliance period and the use of phony offshore shell companies have always been in direct violation of the regulation as it was written literally, therefore the amendments will probably do no more than just make it more difficult for these abuses to occur. Regardless of the changes brought about by the amendments and the Commission's attempts to curb abuses in the regulation, intentional abusers that knowingly violate the regulation will most likely continue to abuse it. There is only so much that the Commission can do, absent enforcement action, to prevent these type of abusers from violating the securities laws.

A look at the amendments' probable impact on abuses of the regulation should provide some guidelines for whether these abuses will continue in the future. Some of these abuses could become more or less prevalent in the future, not necessarily because the amendments did or did not adequately address them, but because there may be more or fewer incentives for the abuses to occur.

1. *Illegal Resales Within the Distribution Compliance Period*

A problem that may become prevalent in the future involves the resale of Regulation S securities by foreign purchasers during the distribution compliance period.³²¹ Larger discounts offered by issuers in light of newer restrictions imposed by the amendments might provide a greater incentive for purchasers to resell their securities as soon as possible. Purchasers might want to capitalize on the immediate reward of gains from selling their discounted securities at prevailing market prices without having to wait out the distribution compliance period. However, the illegal resale problem could also become less of a problem in the future as a result of these same larger discounts being offered on Regulation S securities.

³²⁰ See Amending Release, *supra* note 4, at 9632-33.

³²¹ See *supra* pp. 75-76 and notes 100-04 and accompanying text.

Larger discounts may have the effect of providing comfort to purchasers who must endure the distribution compliance period because such purchasers will be less likely to incur losses when they sell their securities at the end of the distribution compliance period. While there might be more or less incentive for those wishing to commit this type of abuse, there are more safeguards and devices in the regulation to prevent it from happening. This is particularly true with respect to domestic reporting issuers for whose securities the new transactional restrictions pertinent to these issuers now make resale difficult for purchasers within the distribution compliance period.³²²

Domestic reporting issuers need to be aware of illegal resales because these issuers are now required to refuse to register any transfer of securities not made in accordance with the rules governing Regulation S.³²³ The Commission noted that this rule places "on issuers a monitoring role similar to that which is often imposed in connection with unregistered private placements" and warned that, "[i]n light of the abuses in this area, domestic reporting issuers should be held more accountable for compliance in these offerings."³²⁴ Therefore, domestic reporting issuers need to be alert to those attempting to illegally resell or wash off restrictions in the resale and transference of securities. This new monitoring role on the part of domestic reporting issuers will make it harder for such illegal resales to occur.³²⁵

2. *Creation and Use of Phony Offshore Shell Entities*

The amendments will probably not have an immediate impact on the fraudulent use of phony offshore shell entities as a means for issuers to purchase and sell unregistered Regulation S securities in the United States.³²⁶ However, the extension of the distribution compliance period to a full year will most likely lessen the incentives for these abuses to occur in the future.

³²² See Amended Regulation S, 17 C.F.R. § 230.903(b)(3)(iii)-(iv) (1998).

³²³ See *id.* § 230.903(b)(3)(iii)(B)(4).

³²⁴ Amending Release, *supra* note 4, at 9636.

³²⁵ See *id.*

³²⁶ See *supra* Part IV.A.2 and notes 105-23 and accompanying text. The prohibition against the use of phony offshore shell companies for the purchase of securities under Regulation S has already been stated clearly in the regulation. Accordingly, there was not much that the Commission could have done against these abuses absent aggressive enforcement action. See Amended Regulation S, 17 C.F.R. § 230.902(k)(1)(viii) (1998). The regulation itself specifically outlaws the creation and use of phony shell companies by categorizing corporations formed overseas by U.S. persons for the purpose of investing in unregistered securities as U.S. persons, thereby prohibiting them from purchasing securities under Regulation S. See *id.* These schemes are generally orchestrated and planned out and, as the *Sung* case illustrated, can have criminal implications attached to them along with SEC enforcement liability. See *Sung*, 61 SEC Docket at 2275. See also *supra* Part IV.A.2 and notes 116-22 and accompanying text.

Under the regulation, purchasers of Category Three securities are required to certify that they are not U.S. persons and are not acquiring the securities for the account or benefit of a U.S. person.³²⁷ The Commission felt that the expansion of this certification requirement in the amendments to include equity securities of domestic reporting issuers would prevent some of the abuses involving the use of phony offshore shell entities.³²⁸ However, the expansion of this certification requirement will probably only serve as additional notice to those already considering the perpetration of such fraud, reinforcing the fact that a use of these entities is a violation of the law.³²⁹

While the certification and other transactional restrictions under Category Three will probably not in themselves deter abuses involving phony offshore shell entities, the extension of the distribution compliance period to a full year probably will. Those wishing to park securities in phony offshore shell entities most likely wish to see an immediate to near-term gain. Therefore, they will not want to be involved in an offshore parking scheme that has to go on for a full year as opposed to only 40 days because many things can happen in a year. The SEC might find them, companies could go bankrupt, or the market might just collapse. An extension to a full year is even more of a problem in that these schemes are often associated with false filings and other forms of manipulation to drive a stock's share price up to an inflated level before the shares are dumped back into the United States.³³⁰ These "pump and dump" schemes, utilizing phony offshore shell entities, are very difficult to execute and maintain for a full year. A year provides more time for the market to realize that a stock is grossly overvalued; and when it does, the market and the short-sellers in it will expose the stock for what it is truly worth. A full year also allows more time for the SEC to spot an illegal manipulation in the works.

³²⁷ See Amending Release, *supra* note 4, at 9636; Amended Regulation S, 17 C.F.R. § 230.903(b)(3)(iii)(B)(1) (1998). This certification requirement was required for securities covered under the original Category Three. See Original Regulation S, 17 C.F.R. § 230.903(c)(3)(iii)(B)(1) (1990). With the amendments, however, this requirement now also applies to equity securities of domestic reporting issuers. See Amended Regulation S, 17 C.F.R. § 230.903(b)(3)(iii)(B)(1) (1998).

³²⁸ See Amending Release, *supra* note 4, at 9636.

³²⁹ Those that have been involved in these types of schemes probably already knew that these schemes were against the law anyway and therefore any additional notice will probably just be fruitless. See Amended Regulation S, 17 C.F.R. § 230.902(k)(1)(viii) (1998).

³³⁰ See *supra* Part IV.A.2 and notes 108-23 and accompanying text. In *Softpoint*, it was alleged that proceeds from the sale of unregistered Regulation S securities were disguised as proceeds from corporate sales. See *Softpoint*, 59 SEC Docket at 426. In *Sung*, the SEC alleged that a series of manipulative activities led the stock price to go from \$4.00 per share to \$12.00 per share in only three months. See *Sung*, 61 SEC Docket at 2275. In *Osheroff* it was alleged that a series of false press releases were issued to increase the price of the stock. See *Osheroff*, 66 SEC Docket at 2531.

3. *Use of Promissory Notes*

By adopting amendments that effectively toll the one year holding period in purchases using promissory notes and provide that domestic securities offered under Regulation S cannot be resold until such promissory notes are completely paid off, the Commission addressed the problem concerning the misuse of promissory notes under the regulation.³³¹ Schemes involving promissory notes, where purchasers did not have to pay anything for their Regulation S shares before reselling them, are specifically disallowed under the regulation, as such purchasers are now required to pay their promissory notes in full before they can resell their securities in the United States.³³²

It is good that the Commission addressed what it considered to be the improper use of promissory notes in the amendments.³³³ Prior to the Commission's Problematic Practices Release and enforcement action in the *Candie's* case, it was not clear that the use of promissory notes at issue in *Candie's* was necessarily prohibited by the securities laws.³³⁴

4. *Use of the Resale Safe Harbor to "Wash Off" Restrictions from Otherwise Restricted Securities*

The Commission directly addressed the problem of the resale safe harbor being used as a means to wash off restrictions from otherwise re-

³³¹ See *supra* Part IV.A.3 and notes 124-34 and accompanying text.

³³² See Rule 144, 17 C.F.R. § 230.144(d)(2) (1997).

³³³ The Commission decided to take the Rule 144 approach to combat abuses concerning promissory notes because it did not want to prohibit the use of promissory notes altogether as payment for securities offered under Regulation S. See Amending Release, *supra* note 4, at 9637. Such an approach had been considered by the Commission in its proposed amendments to Regulation S. See Proposed Amendments Release, *supra* note 152, at 9262-63. Under the new approach adopted, promissory notes can still be accepted as payment for purchases of domestic equity securities under Regulation S, but under Rule 144, the resale of securities into the U.S. markets cannot be used to raise funds to pay off such promissory notes. See Amending Release, *supra* note 4, at 9637.

³³⁴ See Problematic Practices Release, *supra* note 96, at 35,664. See generally *Candie's*, Securities Act Release No. 7263, 61 SEC Docket 758 (Feb. 21, 1996). The Problematic Practices Release did not come out until June 27, 1995. See Problematic Practices Release, *supra* note 96, at 35663. The promissory note transactions found to be violations of Regulation S in the *Candie's* case occurred in 1993, before the Problematic Practices Release was released. See *Candie's*, 61 SEC Docket at 759-61. Oddly, in the release instituting administrative proceedings and simultaneously accepting offers of settlements in the *Candie's* case, the Commission cites the Problematic Practices Release as one of its basis for finding violations of the law regarding the use of promissory notes. See *id.* at 761. Therefore the Problematic Practices Release appears to have been cited on an apparently retroactive basis. See *id.* It is surprising that Commissioner Wallman did not dissent in the *Candie's* case in light of his dissent in the *GFL Ultra Fund* case against violations being found for transactions not specifically delineated as being violative prior to the Problematic Practices Release. See *GFL Ultra Fund*, 64 SEC Docket at 1961-62.

stricted securities in its new Rule 905.³³⁵ With the amendments, it is clear that the resale safe harbor cannot be used to wash off the restricted securities classification pertinent to equity securities of domestic issuers.³³⁶ The amended Regulation S now effectively outlines this rule, whereas prior to the amendments this rule was only specifically addressed in the Commission's Problematic Practices Release and subsequent no-action letter.³³⁷

There may be strong incentives for persons to try and wash off restrictions from otherwise restricted securities purchased under Regulation S in light of probable greater discounts being offered as a result of the amendments.³³⁸ However, persons seeking to do so will probably have a more difficult time given the more stringent safeguards imposed through the Category Three transactional requirements.³³⁹

5. Hedging

The most controversial violation in the regulation involving hedging was not clarified in the amendments.³⁴⁰ In the amendments, the Commission oddly placed anti-hedging provisions in the Category Three transactional and offering restrictions but did not explicitly provide in the regulation what, if any, hedging transactions are prohibited under Regulation S.³⁴¹ There is also no framework for when hedging transactions can take place "in compliance with the Act" as provided for in the new anti-hedging provisions under Category Three.³⁴²

³³⁵ See Amended Regulation S, 17 C.F.R. § 230.905 (1998). See also *supra* Part IV.A.4 and notes 135-37 and accompanying text.

³³⁶ See Amended Regulation S, 17 C.F.R. § 230.905 (1998).

³³⁷ See Problematic Practices Release, *supra* note 96, at 35,664; In Touch Global, LLC, *supra* note 137, at 77,038-39.

³³⁸ Like the abuses associated with illegal resales during the distribution compliance period, there may be strong incentives for persons to wash off restrictions from their securities and immediately capitalize on their discounted purchases by reselling their securities at the prevailing market price. See *supra* p. 111 and note 321.

³³⁹ See Amended Regulation S, 17 C.F.R. § 230.903(b)(3)(iii)(iv) (1998).

³⁴⁰ See *supra* Part IV.A.5 and notes 138-61 and accompanying text.

³⁴¹ See Amended Regulation S, 17 C.F.R. §§ 230.902(g)(1)(ii), 230.902(g)(2), 230.903(b)(3)(iii)(B)(2)-(3) (1998). The Commission amended Category Three to mandate that purchasers of these securities agree "not to engage in hedging transactions with regard to such securities unless in compliance with the Act." *Id.* § 230.903(b)(3)(iii)(B)(2). The Commission also amended Category Three to require that the legend on these securities state, among other things, that "hedging transactions involving those securities may not be conducted unless in compliance with the Act." *Id.* § 230.903(b)(3)(iii)(B)(3). The offering restrictions applicable to domestic issuers now also require that distributors agree in writing not to engage in hedging transactions prior to the expiration of the distribution compliance period unless in compliance with the Act. See *id.* § 230.902(g)(1)(ii). Offering materials used in connection with the offering also need to state that hedging in these securities is prohibited unless in compliance with the Act. See *id.* § 230.902(g)(2).

³⁴² *Id.* §§ 230.902(g)(1)(ii), 230.902(g)(2), 230.903(b)(3)(iii)(B)(2)(3).

The Commission stated in the release accompanying the amendments that "the amendments do not impose any new restrictions on hedging practices."³⁴³ This statement could be taken to mean that the status quo of the Commission's position regarding hedging underlying the *GFL Ultra Fund* case continues to govern.³⁴⁴ Likewise, it appears that the unanswered questions and vague legal analysis of the *GFL Ultra Fund* case also continue to govern.³⁴⁵ The Commission did note in the release accompanying the amendments that it was considering proposed restrictions on hedging under Rule 144.³⁴⁶ These restrictions would definitely provide helpful insight as to the role of hedging under Regulation S.³⁴⁷

The *GFL Ultra Fund* case found the Fund involved in hedging to have purchased Regulation S securities with a view towards distribution thus making it a statutory underwriter required to register its shares before reselling them.³⁴⁸ The *GFL Ultra Fund* case did not state whether investors engaged in hedging activities of fewer transactions than those of the Fund

³⁴³ See Amending Release, *supra* note 4, at 9635 n.28.

³⁴⁴ See generally *GFL Ultra Fund*, Administrative Proceeding Release No. 3-9333, 64 SEC Docket 1958 (June 18, 1997).

³⁴⁵ See *id.* at 1959-61. In light of the broad statement in the *GFL Ultra Fund* case that a "trading pattern of short selling in the United States in connection with purchasing in a Regulation S offering which essentially locks in a profit . . . runs counter to the goals of Regulation S," a lot of uncertainty still exists as to the liability an individual can incur if he chooses to engage in short selling associated with discounted purchases under Regulation S. See *GFL Ultra Fund*, Administrative Proceeding Release No. 3-9333, 64 SEC Docket at 1961. See also *supra* p. 83 and note 151.

³⁴⁶ See Amending Release, *supra* note 4, at 9635 n.28. See also Revision of Rule 144, Rule 145 and Form 144, *supra* note 199, at 9252-53. The Commission sought comments on four regulatory approaches to hedging as applied to Rule 144. See *id.* at 9252. The first approach was considering making the Rule 144 safe harbor unavailable for persons who hedge during the restricted period. See *id.* The second approach proposed promulgating a rule that would define certain specified hedging transactions as sales for purposes of Section 5. See *id.* Therefore, such hedging transactions would need to be registered or subject to an exemption. See *id.* The third approach proposed adopting a shorter holding period of possibly three to six months in which hedging would not be allowed to occur without losing the Rule 144 safe harbor. See *id.* Thereafter, hedging could occur, but the underlying restricted securities would have to be held for the remainder of the one year holding period under Rule 144. See *id.* The fourth approach proposed reintroducing a tolling provision to Rule 144, similar to a provision that was included prior to 1990, which would not specifically prohibit hedging but would instead rely upon practitioners to apply a facts-and-circumstances test to determine when Section 5 is implicated. See *id.*

³⁴⁷ See Revision of Rule 144, Rule 145 and Form 144, *supra* note 199, at 9252. However, such a remedy utilizing a formula intermixing Regulation S with Rule 144 might not be the most coherent way of doing so. This is the same kind of formula that was used in the abuses concerning the use of promissory notes and the resale safe harbor as a means to wash off restrictions. See *supra* Part VII.B.3 and notes 331-39 and accompanying text.

³⁴⁸ See *GFL Ultra Fund*, 64 SEC Docket at 1961. See also *supra* pp. 82-83 and notes 145-50 and accompanying text.

could also be held liable for violations of the securities laws.³⁴⁹ Now that there are anti-hedging provisions in the Category Three offering and transactional restrictions, this area of liability has become even more uncertain.³⁵⁰ This is especially true now that purchasers of Category Three securities are required to agree not to engage in hedging activities in these securities "unless in compliance with the Act."³⁵¹ In light of this new purchaser agreement requirement, it is questionable whether purchasers who would not be considered statutory underwriters under the *GFL Ultra Fund* analysis could still be in violation of the regulation through the purchasing agreement.³⁵²

Another question left open by the amendments, as applied to hedging, relates to the new one year holding period for domestic reporting issuers. In *GFL Ultra Fund*, the Fund was construed as a statutory underwriter because it had purchased Regulation S shares with a view towards distribution.³⁵³ Now that the holding period for securities of domestic reporting issuers is one year as opposed to 40 days, it is questionable whether a purchaser holding such securities for this longer period would actually be purchasing these securities with a view towards distribution.³⁵⁴

Whether the amendments will actually deter hedging in Regulation S is questionable. There is much uncertainty in this area and the amendments have only served to add to it. If anything, this uncertainty by itself might be the best deterrence in the regulation against hedging.

³⁴⁹ The Fund at issue in the *GFL Ultra Fund* case engaged in a short selling strategy in approximately sixty-two Regulation S deals. See *GFL Ultra Fund*, 64 SEC Docket at 1959.

³⁵⁰ Now that purchasers have to agree not to engage in hedging transactions, and the legend and offering materials provide that such hedging activities are not allowed "unless in compliance with the Act," it is questionable whether purchasers not engaged in a substantial number of hedging activities can escape liability for hedging violations simply by relying on the section 4(1) exemption. See Securities Act of 1933 § 4(1), 15 U.S.C. § 77(d)(1) (1994); and Amended Regulation S, 17 C.F.R. §§ 230.902(g)(1)(ii), 230.902(g)(2), 230.903(b)(3)(iii)(B)(2)-(3) (1998).

³⁵¹ Amended Regulation S, 17 C.F.R. § 230.903(b)(3)(iii)(B)(2) (1998).

³⁵² In the release accompanying the amendments, the Commission stated that issuers "would be free to require purchasers not to engage in any hedging transactions, even if the transaction would be consistent with the Securities Act." Amending Release, *supra* note 4, at 9635 n.28. It is questionable, therefore, whether purchasers required to agree not to engage in hedging transactions are liable in any way for violating such agreements even though their hedging activities would be deemed to be in compliance with the Securities Act absent these purchasing agreements.

³⁵³ See *GFL Ultra Fund*, 64 SEC Docket at 1960.

³⁵⁴ See *id.* This intent factor might be very hard to prove absent such a purchaser immediately short selling the same amount and type of securities as it had purchased through Regulation S.

C. Probable Impact of Amendments on Marketplace Concerns

The new amendments will definitely have an impact on concerns in the marketplace about the regulation.³⁵⁵ In particular, the amendments will affect the discount, disclosure, and dilution aspects of the regulation that have generated in the marketplace allegations of an unfair and exclusive advantage to foreign investors.³⁵⁶ A look at how the amendments should impact on these three attributes should assist in predicting whether there will be continued scrutiny of the regulation by the marketplace.

1. Greater Discounts Will Be Offered By Domestic Issuers

Securities offered under Regulation S will probably be offered at greater discounts to the prevailing market price by domestic issuers due to equity securities of domestic reporting issuers now being subject to a holding period of one year, as opposed to 40 days.³⁵⁷ The risks that purchasers will now have to undergo as a result of waiting a full year will cause less demand for these securities and greater discounts offered to entice buyers for them.³⁵⁸ These discounts will be even more necessary given the expansion of the transactional restrictions and the restricted securities classification to securities of domestic issuers which will make these securities less liquid and more restricted within the marketplace.³⁵⁹

Nonreporting domestic issuers will probably now have to offer very large discounts to the prevailing market price to remain somewhat competitive with reporting issuers. Domestic reporting issuers are now subject to the same type of restrictions as domestic nonreporting issuers; however, the securities of reporting issuers are much more tradable in the marketplace. Therefore, domestic nonreporting issuers will probably need to offer very attractive discounts to attract purchasers who might otherwise choose to buy Regulation S securities offered by reporting issuers.

2. Dilution May Become a Problem Depending on the Discounts Offered

The potential of greater discounts being offered due to heavier restrictions on domestic equity securities may or may not play a role in the dilutive problems associated with the regulation. If discounts offered are so great that purchasers will patiently wait out a year to capitalize on enormous potential profits, then at the end of the distribution compliance pe-

³⁵⁵ See *supra* IV.B.1-3 and notes 163-78 and accompanying text.

³⁵⁶ See *id.*

³⁵⁷ See Amended Regulation S, 17 C.F.R. § 230.903(b)(3)(iii)(A) (1998).

³⁵⁸ The Commission has acknowledged that it expects discounts on Regulation S securities to grow as a result of the increase in the distribution compliance period from 40 days to one year. See Amending Release, *supra* note 4, at 9639. The Commission noted, however, that it could not determine how large this increase was likely to be. See *id.*

³⁵⁹ See Amended Regulation S, 17 C.F.R. §§ 230.903(b)(3)(iii)-(iv), 230.905 (1998). See also Rule 144, 17 C.F.R. § 230.144(a)(3)(v) (1997).

riod, there will be an immediate and more imminent flowback of securities to the United States.³⁶⁰ This flowback will in turn dilute the stock and cause share prices to fall. Therefore, large discounts, if extremely attractive, could make the dilution problem even more poisonous than before. However, if discounts offered are not very attractive, then offshore purchasers will probably not purchase these securities at all. Then, of course, there would be no dilution problem because there would be no securities to flow back into the United States. Thus, there will be a balancing act in the marketplace between discounts being offered and the foreign purchaser's willingness to wait out the one year restricted period.³⁶¹ Following the amendments, at least a year is needed to determine whether flowback will continue to be a problem in the regulation.

3. *Disclosure May Become a Problem*

The most important marketplace concern addressed by the amendments is the issue of disclosure. In the amendments, the Commission modified but maintained a Regulation S reporting requirement when it eliminated the fifteen day Form 8-K reporting in favor of quarterly reporting.³⁶² Quarterly reporting should provide adequate disclosure to current shareholders about an issuer's Regulation S offering before any of the dilutive harms associated with the offering can be felt on the market price of the existing shares. This will also give shareholders the chance to complain to the issuer when these offerings involve discounts that might be perceived as too high. The days when issuers could sell their securities

³⁶⁰ The Commission has noted that "securities sold offshore at a discount from the U.S. market price are likely to be resold in the United States at the earliest possible date for the purchaser to realize a profit." Proposed Amendments Release, *supra* note 152, at 9265.

³⁶¹ The dilutive harms associated with Regulation S offerings can still be profitable for short-sellers even though the distribution compliance period has been lengthened from 40 days to a full year. See *supra* note 178 and accompanying text. Short-sellers can browse through quarterly filings to find numerous securities offerings under Regulation S. The short seller can then pick a particular offering in which securities were offered at large discounts to the prevailing market price and calendar a date a little less than a year after this initial offering. This later date would represent a time right before the one year holding period would end and the securities could be sold back into the United States. If, at this later date, the prevailing market price is still a lot higher than the price in which the securities were originally offered, then the short seller could sell short right before the one year holding period ends, then cover his short positions after the one year holding period has ended and foreigner purchasers have wreaked havoc on the share price by dumping their shares in the United States and diluting the stock. This may have been easier to do prior to the amendments when there was a 40 day holding period, but it can still be done today with a one year holding period.

³⁶² See Amending Release, *supra* note 4, at 9637. See also *supra* Part VI.C.1 and notes 296-98 and accompanying text.

offshore under Regulation S at any price they wanted without informing their existing shareholders should be a thing of the past.³⁶³

While the disclosure requirements should be enough to give current shareholders the chance to protect themselves from the dilutive harms associated with the flowback of securities, this disclosure may not be timely enough if the market hears of a Regulation S offering before the shareholders do. News of a Regulation S offering can lead to the short selling of an issuer's stock and consequently can cause the issuer's stock price to fall. Quarterly reporting will not give existing shareholders the chance to sell their shares before such a fall because professionals in the market will most likely find out about a Regulation S offering before current shareholders do.

VIII. RECOMMENDATIONS SHOULD ABUSES OF THE REGULATION CONTINUE AFTER THE AMENDMENTS

Whether the amendments will deter ongoing abuses in the regulation remains to be seen. Some abusers of the regulation may never be deterred absent enforcement action by the SEC. Other abusers may not even know or realize that they are violating the regulation. For this reason, if abuses do not stop with the amendments, the Commission should better identify the abuses of the regulation and follow a clarified regulation with aggressive enforcement action. If this two step approach is followed, then the regulation should be cleaned of violators of the regulation who have tainted the regulation's validity in the marketplace since its promulgation.

A. Clarify Regulatory Abuses or Law Regarding Abuses of the Regulation

1. *The Need for Clarity*

In the past, the Commission's interpretation of Preliminary Note 2 has served as notice from the SEC of what it considers to be a violation of Regulation S.³⁶⁴ The Commission laid out a framework of what it perceived to be violations in its Problematic Practices Release.³⁶⁵ However,

³⁶³ See Morgenson, *supra* note 102, at 37. However, the quarterly disclosure requirement may still not provide enough information to unsophisticated investors who do not customarily comb through quarterly reports.

³⁶⁴ See Amended Regulation S, 17 C.F.R. Preliminary Note 2 (1998); Problematic Practices Release, *supra* note 96, at 35,664. See also note 131 and accompanying text. See generally Candie's, Securities Act Release No. 7263, 61 SEC Docket 758 (Feb. 21, 1996). Preliminary Note 2 is not altogether clear when it states that Regulation S is not available for any transaction or series of transactions that are schemes to evade the registration requirements of the Act. See Amended Regulation S, 17 C.F.R. Preliminary Note 2 (1998).

³⁶⁵ See Problematic Practices Release, *supra* note 96, at 35,663-64. See also *supra* Part V.B and notes 184-90 and accompanying text. However, the Problematic Practices Release was an interpretative release not contained within the regulation itself. See Problematic Practices Release, *supra* note 96, at 35,663. It is recommended that these abuses should be

the SEC found violations of the regulation in *Candie's* and *GFL Ultra Fund* for transactions that occurred before the Problematic Practices Release formally labeled certain uses of promissory notes and hedging as prohibited.³⁶⁶ This apparent retroactive application of what the Commission deemed to be violations of Regulation S can strike fear into those seeking to comply with the regulation.

The uncertainty in the regulation, the lack of clarity in Preliminary Note 2, and the Commission's ability to render decisions on an almost retroactive basis appears to have made many practitioners overly cautious when structuring Regulation S transactions. This is probably why a Commission survey done prior to the amendments found that practicing attorneys dealing in Category Two domestic equity securities were also complying with the Category Three certification and legending requirements "as a matter of common practice."³⁶⁷ These attorneys probably were not satisfying such unnecessary and additional requirements without reason. They were most likely meeting these requirements to protect themselves from the dreadful day when the SEC came knocking on their door.

If the amendments do not limit or end abuses in the regulation, then it is recommended that the regulation be clarified to outline what the Commission considers to be violations. A clarified, more understandable, and stronger regulation that more specifically addresses abuses of the regulation itself should serve to create more certainty and confidence in the compliance and use of the regulation.³⁶⁸

2. *Ways to Clarify the Regulation*

There are two ways that the Commission could clarify the prohibitions associated with Regulation S. The Commission could state what it deems

identified more clearly, either by stating that they are prohibited or by clarifying the law regarding these abuses within the regulation itself.

³⁶⁶ See *Candie's*, 61 SEC Docket at 761; *GFL Ultra Fund*, 64 Sec Docket at 1961-63. This is one of the reasons why former Commissioner Wallman dissented in the *GFL Ultra Fund* case. See *id.* at 1962-63. He noted that "the Commission failed to make any formal pronouncements regarding Regulation S until the issuance of the Problematic Practices Release." *Id.* at 1962. He further noted that it was in the Problematic Practices Release that "the Commission raised concerns about hedging in the U.S. markets by purchasers of Regulation S securities during the restricted period." *Id.* Therefore, he felt that bringing an "after the fact" enforcement case for transactions that took place before the issuance of the Problematic Practices Release was not warranted. See *id.* See also *supra* pp. 83-84 and notes 153-55.

³⁶⁷ Amending Release, *supra* note 4, at 9639.

³⁶⁸ The issue of the Commission's sometimes vague construction of the securities laws has received a lot of attention lately as it appears that some courts are criticizing the Commission for its lack of specific standards when defining certain types of misconduct under the securities laws. See Paul Beckett, *Lack of SEC Rules Irks Appeals Courts*, WALL ST. J., Apr. 14, 1998, at B7. See also *Checkosky v. SEC*, 139 F.3d 221 (D.C. Cir. 1998); *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998).

to be abuses directly in the regulation itself, possibly within the preliminary notes section. However, an outline of abuses should not be too exclusive because such overregulation can have the danger of enabling other loopholes to arise. A second approach would be to rewrite the regulation to clarify the laws as they pertain to abuses. In this regard, the provisions concerning the abuses could be delineated more clearly rather than overlapping Rule 144 with Regulation S. The laws as they apply to abuses could also be outlined better so that those seeking to comply will know exactly what is prohibited by a simple reading of the regulation.

(a) Promissory Notes

(i) Incorporate Rule 144 Promissory Note Provisions Directly Into Regulation S

The Commission's approach in dealing with abuses concerning promissory notes now requires a reading of the Rule 144 provisions with the rules governing Regulation S.³⁶⁹ This overlap of Rule 144 with Regulation S, while a good effort by the SEC, does not directly address promissory notes within the regulation. If the promissory note problem continues, then the tolling and resale provisions governing promissory notes under Rule 144 should be specifically written within Regulation S. These provisions can be written in the regulation separately from any restricted securities analysis or other reading under Rule 144. The regulation could, in effect, have the Rule 144-type provisions apply to the issuer safe harbors and tie in the distribution compliance period as the holding period applicable to those provisions. This would provide a better understanding of what the rules are relating to the use of promissory notes and not require a reading of a separate regulation.

(ii) Recommendations Concerning Promissory Notes If A More Clarified Regulation does not Work

(a) *Toll the One Year Holding Period Until Promissory Notes Are Fully Paid*

If the Commission's formula for solving the promissory note problem does not work, the SEC could toll the one year distribution compliance period or holding period until the promissory note is fully paid. Under the amendments incorporating the Rule 144 promissory note provisions to domestic issuers covered under Regulation S, the holding period will not begin to run until the promissory note provides for full recourse against the purchaser of the securities and is secured by collateral having a fair market

³⁶⁹ See Amended Regulation S, 17 C.F.R. § 230.905 (1998); Rule 144, 17 C.F.R. § 144(d)(2) (1997).

value at least equal to the purchase price of the securities purchased.³⁷⁰ After the holding period requirement has been satisfied, the promissory note must then be fully paid before there can be a resale of the securities bought under Regulation S.³⁷¹ Once the promissory note is paid, the securities can be resold immediately. A purchaser could always borrow money to pay off the promissory note, sell his Regulation S securities right away and then use the proceeds to repay the lender. In reality, the purchaser would be repaying the promissory note with proceeds from the resale of Regulation S securities. Therefore, the promissory note problem, where the expectation of repayment stems from the resale of Regulation S securities back into the U.S. market, can still occur via a lender being used as a middleman. The best way to avoid this potential problem is to toll the one year distribution compliance period or holding period until the promissory note has been fully paid.

(b) *Prohibit the Use of Promissory Notes Altogether as Payment for Regulation S Securities*

The most drastic recommendation if the promissory note problem continues after the amendments is to prohibit the use of promissory notes altogether as payment for domestic equity securities offered under the regulation. This type of prohibition was originally proposed by the Commission in its proposed amendments to Regulation S.³⁷² If this measure is considered too extreme, an alternative would be to limit such a prohibition to only non-recourse promissory notes.

(b) *Place more Clarifying Language in the Regulation Stating that the Resale Safe Harbor Cannot be Used to "Wash Off" Restrictions*

The use of the resale safe harbor as a means for washing off restrictions from otherwise restricted securities has been delineated as prohibitive to an extent under Rule 905.³⁷³ However, as with the case of promissory notes, the Commission again overlapped Rule 144 with Regulation S by stating that the resale safe harbor could not be used to wash off restrictions from otherwise restricted securities within the meaning of Rule 144.³⁷⁴

The Commission's formula of intermixing Rule 144 with Regulation S might very well provide adequate notice that the resale safe harbor cannot

³⁷⁰ See Rule 144, 17 C.F.R. § 230.144(d)(2)(i)(ii) (1997).

³⁷¹ See *id.* § 230.144(d)(2)(iii); Amending Release, *supra* note 4, at 9637.

³⁷² See Proposed Amendments Release, *supra* note 152, at 9262-63. The proposed amendments to the regulation would have put a provision within Category Three stating that "no promissory note" could "be received as payment" for securities offered under Regulation S. See *id.* at 9274. This provision would have been contained in a proposed section 230.903(b)(3)(iv)(B)(5). See *id.*

³⁷³ See Amended Regulation S, 17 C.F.R. § 230.905 (1998).

³⁷⁴ See *id.*

be used as an avenue for washing off restrictions. However, if problems continue in this area after the amendments, the Commission should consider putting in a blanket statement within the regulation itself prohibiting the use of the resale safe harbor as a means for washing off restrictions. Such a statement could be put either in the resale safe harbor or in the preliminary notes section of the regulation. The Commission could also try using some of the language it had previously used in its Problematic Practices Release and the *In Touch Global, LLC* no-action letter.³⁷⁵ Some of this language included a statement to the effect that "Rule 904 cannot be used for the purpose of washing off resale restrictions, such as the holding period requirement for restricted securities in Rule 144."³⁷⁶ Another statement provided, "If a person with restricted securities sold the securities in an offshore transaction and replaced them with a repurchase of fungible unrestricted securities, the replacement securities would be subject to the same restrictions as those replaced."³⁷⁷ Either or both of these two statements within the regulation should help make clear that the resale safe harbor cannot be used to wash off restrictions without there being any kind of separate reading required under Rule 144.

(c) Hedging Activities Prohibited Under the Regulation Need To Be Delineated in the Regulation

The prohibitions against hedging should be specifically spelled out in some form within the Regulation. The Commission is talking about adding provisions dealing with hedging under Rule 144 which would be applicable to restricted securities under Regulation S.³⁷⁸ This approach, while using Rule 144 as an avenue to address hedging, would be better than the status quo being that the Commission has not addressed the issue of hedging in any way within the regulation itself.

The *GFL Ultra Fund* case found hedging in Regulation S to be prohibited, and the amendments added new anti-hedging provisions applicable to securities offered by domestic issuers.³⁷⁹ Yet the amending release stated that the amendments did not impose any new restrictions on hedging under the regulation.³⁸⁰ In light of these conflicting standards and unanswered questions about hedging, the Commission needs to delineate what

³⁷⁵ See Problematic Practices Release, *supra* note 96, at 35664; *In Touch Global, LLC*, *supra* note 137, at 77,039.

³⁷⁶ *In Touch Global, LLC*, *supra* note 137, at 77,039.

³⁷⁷ *Id.*

³⁷⁸ Revision of Rule 144, Rule 145 and Form 144, *supra* note 199, at 9252-53. See also *supra* p. 116 and notes 346-47 and accompanying text.

³⁷⁹ See *GFL Ultra Fund*, 64 SEC Docket at 1961; Amended Regulation S, 17 C.F.R. §§ 230.902(g)(1)(ii), 230.902(g)(2), 230.903(b)(3)(iii)(B)(2)-(3).

³⁸⁰ See Amending Release, *supra* note 4, at 9635 n.28.

forms of hedging are prohibited in the regulation.³⁸¹ The lack of unanimous Commission support in the *GFL Ultra Fund* case and the spotty and somewhat conflicting references to hedging in the amendments cannot serve as valid notice to the investing public as to what hedging activities are prohibited in the regulation.

(d) Abuses Concerning Illegal Resales and Phony Offshore Shell Entities
Do Not Need To Be Better Clarified In the Regulation

Abuses concerning resales within the distribution compliance period and the use of phony offshore shell entities probably do not necessitate much more clarity than what is already provided by the regulation. The regulation plainly states that a sale of Regulation S securities cannot be made in the United States within a respective distribution compliance period.³⁸² The regulation also provides that a corporation formed overseas by a U.S. person for the purposes of investing in unregistered securities will still be deemed a U.S. person and, therefore, unable to purchase securities under the regulation.³⁸³ These provisions are fairly straightforward and there is probably no need to repeat or clarify them in the regulation. Therefore, the second step recommendation of aggressive enforcement action is only recommended as against these types of abuses.

B. Aggressive Enforcement Action

Once violations of Regulation S are laid out in some clear format for the securities industry to understand, the Commission's enforcement staff should weed out abusers of the regulation. These enforcement actions should not serve to alarm practitioners seeking to validly use the regulation, because such practitioners would know that these enforcement actions were warranted in light of a clarified regulation. A clarified Regulation S will serve as a sword for the SEC and a shield for those seeking to validly comply, leaving abusers out in the open to be slaughtered.

Enforcement actions by themselves cannot resolve all of the problems occurring in the regulation due to the limited resources available to the SEC. However, a clarified regulation, together with a strong and visible enforcement program directed at abusers, should provide a strong deterrence against abuses of the regulation in the future. Then, with time, Regulation S may become a valid and respectable means of raising capital in the financial marketplace.

³⁸¹ One of the most important issues left up in the air is whether individual investors can be held accountable for hedging activities in association with discounted purchases of securities offered under Regulation S. See *supra* p. 84 and notes 156-57.

³⁸² See Amended Regulation S, 17 C.F.R. §§ 230.902(f), 230.903(b)(2)(ii), 230.903(b)(3)(ii)(A), 230.903(b)(3)(iii)(A) (1998).

³⁸³ See *id.* § 230.902(k)(1)(viii).

C. Foreign Issuers Should Be Left Alone

The two step recommendation of clarifying abuses in the regulation followed up with aggressive enforcement action is not recommended against foreign issuers. There has been no evidence of Regulation S abuses involving the securities of foreign issuers; however, the Commission has considered imposing additional restrictions on these issuers in the past.³⁸⁴ Absent the evolution of widespread abuses, foreign issuers should be left alone, and no additional restrictions should be placed on these securities. Securities of foreign issuers have not been a source of abuse and should not be hindered by additional restrictions aimed at halting abuses in the regulation.

IX. RECOMMENDATIONS IF MARKETPLACE CONCERNS CONTINUE AFTER THE AMENDMENTS

The amendments were specifically enacted to address the regulatory abuses occurring under Regulation S.³⁸⁵ In doing so, the amendments also addressed some of the marketplace concerns surrounding the regulation. While the Commission should not seek to directly interfere with the economics of the marketplace, it should arguably correct any unfair advantages it may have unintentionally placed in the markets when those advantages have led to regulatory abuses. The Commission should look closely at and address some of the marketplace concerns when seeking to clean up the regulation if problems continue after the amendments. Two very important marketplace concerns that the Commission should focus on deals with the issues of disclosure and discounts.

³⁸⁴ The Commission had previously proposed subjecting foreign reporting issuers with a principal market in the United States for its securities to the Category Three requirements and restricted securities classification under Rule 144. See Proposed Amendments Release, *supra* note 152, at 9260, 9263. See also *supra* pp. 91-92 and notes 196-99 and accompanying text. In the proposed amendments the Commission conceded that it was not aware of widespread abuses involving the securities of foreign issuers but still felt that a "potential for abuse" existed in these type of securities. Proposed Amendments Release, *supra* note 152, at 9263. The Commission noted that "although abusive practices under Regulation S have not been as evident in offerings by foreign issuers" it was "concerned that the economic incentives for indirect distributions and resales into the United States are the same for equity offerings of both domestic companies, and foreign companies where the principal market for the securities is in the United States." *Id.* at 9263-64. Commentors strongly opposed to these restrictions argued that such restrictions were unwarranted as there were no abuses in this area of the regulation. See Amending Release, *supra* note 4, at 9633. With the commentors objections in mind, the Commission decided not to extend the additional restrictions on foreign issuers. See *id.* However, the Commission warned that it would "monitor practices in this area" and "revisit the issue if abuses occur." *Id.* See also Amended Regulation S, 17 C.F.R. § 230.903(b)(1)(2) (1998). The Commission stated in the amendments that "absent a showing of abuse, imposing significant new restrictions on the offshore offering practices of foreign companies is not warranted." Amending Release, *supra* note 4, at 9633.

³⁸⁵ See Amending Release, *supra* note 4, at 9632.

The most important marketplace concern is the issue of disclosure. Disclosure is the key to letting investors protect themselves. Present shareholders of an issuer doing a Regulation S offering cannot be hurt by the dilutive effects of the offering if they know about and have the chance to sell their shares before the flow of securities back into the United States. In this regard, the discount and marketplace dilution concerns are irrelevant as long as there is disclosure available to existing domestic shareholders. The disclosure of Regulation S offerings should always be mandated.³⁸⁶

The timing of disclosure is also an important factor for the protection of domestic shareholders. At the very least, disclosure should always be required before the end of a distribution compliance period when foreign purchasers can sell their securities back into the United States. Disclosure in advance of an offering would also be very helpful in allowing existing shareholders the chance to sell their securities before the market gets wind of a Regulation S offering. News of an offering can often have the detrimental effect of driving down the existing shareholder's stock price and advance notice of such an offering would give existing shareholders the chance to avoid these harmful market effects.³⁸⁷

As a result of the extension of the distribution compliance period to a full year for domestic issuers, there will probably be fewer complaints in the marketplace about the regulation's unfairness in providing an economic advantage to foreign purchasers. However, if this extension in the holding period results in outlandish discounts being offered, there could be a floodgate of new marketplace concerns about the regulation. Some discounts can be warranted to an extent, but if these discounts become too extreme, then the Commission should think about controlling the discounts that can be offered. The Commission could choose a straight prohibition, limit the discounts, or simply eliminate the availability of the Regulation S safe harbor for discounts beyond a certain specified percentage amount (e.g., discounts greater than 30%).³⁸⁸

³⁸⁶ If the Commission ever decides to lessen the distribution compliance period for Regulation S securities with regard to domestic issuers, it should at least adjust the reporting requirements under Regulation S accordingly to provide for timely disclosure for existing shareholders. Therefore, if for some reason the distribution compliance period is lessened from one year to ninety days or less, then the Commission should scrap the quarterly reporting requirement and go back to a reporting requirement of fifteen days or less. *See supra* Part V.C and notes 191-94 and accompanying text.

³⁸⁷ Advance disclosure of 48 hours or more should provide sufficient notice. The possibility of a negative effect on an issuer's stock price from news of a Regulation S offering takes into consideration that short-sellers often short stocks involved in Regulation S offerings and that many perceive such offerings to be signs of a company's weakening financial state. *See supra* note 178 and accompanying text.

³⁸⁸ Placing a limit on discounts that can be offered has been considered in the past by the Commission. *See* Problematic Practices Release, *supra* note 96, at 35,665; Proposed Amendments Release, *supra* note 152, at 9265. In the Problematic Practices Release, the Commission requested comment on the possibility of excluding certain discounted offers

Overall, if the amendments do not resolve the regulatory problems involving Regulation S, then the regulation should be clarified in a better fashion and the SEC should aggressively pursue abusers who continue to violate the regulation. To curb any complaints about the regulation in the marketplace, disclosure of Regulation S offerings should always be mandated and discounts controlled if they become too extreme. If the amendments or the recommendations noted above serve to clear up problems with the regulation and conform it as an effective and valid means of raising capital, then the Commission should consider relaxing some of the restrictions imposed on domestic reporting issuers.

X. RECOMMENDATIONS IF AMENDED REGULATION BECOMES TOO RESTRICTIVE FOR DOMESTIC ISSUERS IN THE ABSENCE OF ABUSES

Domestic reporting issuers took the hardest hit by the amendments and may have become a casualty as a result of abuses in the regulation. Regulation S may no longer be used by domestic issuers as a means for raising capital offshore because securities offered by these issuers will be less marketable in light of the new offering and transactional restrictions. These issuers will incur higher costs when seeking to comply with the requirements under the regulation. In the end the costs associated with doing a Regulation S offering may not outweigh the costs of simply registering the securities.³⁸⁹

If the Commission did not intend to eliminate the availability of Regulation S as an exemption for domestic reporting issuers, then it should consider relaxing some of the restrictions pertaining to these issuers. When the Commission originally adopted Regulation S, it differentiated the requirements between domestic reporting and nonreporting issuers, given the amount of information about these issuers in the marketplace.³⁹⁰ As there is more information available in the marketplace about reporting issuers

from the issuer safe harbor. See Problematic Practices Release, *supra* note 96, at 35,665. However, in its proposed amendments to the regulation, the Commission decided not to propose requirements specifically limiting the amount of discounts that could be offered, but again requested comment on whether certain discounted offers should be excluded from the safe harbors. See Proposed Amendments Release, *supra* note 152, at 9265.

³⁸⁹ Even the Commission noted in the release accompanying the amendments that "domestic reporting companies that find it too cumbersome to take advantage of the Regulation S safe harbor" when conducting an offering could "simply register under the Securities Act or resort to other exempt offerings." Amending Release, *supra* note 4, at 9636. However, the timeliness of raising capital under Regulation S is still an important benefit of utilizing a Regulation S offering versus going through the registration process.

³⁹⁰ See Adopting Release, *supra* note 1, at 80,675. See also *supra* p. 67 and notes 47-48 and accompanying text.

than nonreporting issuers, these two issuers should probably not be subject to the same restrictions.³⁹¹

If abuses stop in the regulation, the Commission should consider reviving the regulation's resourcefulness as applied to domestic reporting issuers. It should consider a reduction in the distribution compliance period from one year to six months along with an elimination of the restricted securities classification for such securities. It should also consider a reduction of the transactional restrictions back to the Category Two requirements. If, in relaxing these standards, the Commission becomes concerned about large discounts leading to a recurrence of abuses, then the Commission should consider imposing the Category Three requirements, including the one year distribution compliance period, on all discounted offerings by domestic reporting issuers that exceed a specified minimal percentage.³⁹² All of these recommendations should breathe new life into the regulation's usefulness to domestic issuers if the Commission desires to revive the regulation's application in the domestic marketplace.

XI. CONCLUSION

The Commission meant well when it adopted Regulation S back in 1990. The regulation made the offshore markets more accessible to domestic corporations and diminished the cost of raising capital overseas. The securities laws were adjusted to meet the demands of the international marketplace. Unfortunately, loopholes were exploited in the regulation and widespread abuses led to increased scrutiny. The Commission was eventually forced to limit the great financial tool in Regulation S that it had created only earlier in the decade.

The fall of the Iron Curtain and the expansion of economies internationally have led to resources in capital from just about every corner of the world. Regulation S has the potential to be truly responsive to these opportunities. Just because some pirates have exploited the regulation's safe harbors does not mean that the regulation should be destroyed or forgotten. The safe harbors just need to be better protected. With hope, in time the regulation will have the chance to flourish and become one of the more useful regulations in today's global economy.

³⁹¹ Domestic reporting issuers are subject to more requirements than domestic nonreporting issuers because domestic reporting issuers are required to report their Regulation S offerings. See *supra* Part VI.C.1 and notes 296-98 and accompanying text.

³⁹² This was previously considered and requested for comment by the Commission in its Problematic Practices Release. See Problematic Practices release, *supra* note 96, at 35,665.