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INTERNATIONAL CAPITAL MARKETS SECTION

The SEC And Internationalization Of Capital Markets: Herein Of Regulation S And Rule 144A

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§1 REGULATION S AND RELATED INITIATIVES

The Securities and Exchange Commission has made "achieving a truly global market system" a top priority.[1] The Commission's focus on international securities markets led it to revisit a number of its own practices which may have impeded the efficiency of those markets.[2] Commission policy in this area for over two decades was largely determined by mid-level staff through the no action letter process. These policies failed to take into account the increasing institutionalization of markets in general and international capital markets in particular. The overall effect of such policies was to make it difficult and costly for U.S. institutional investors to purchase foreign securities. The extraterritorial application of

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1. *See* press release relating to SEC, "Policy Statement on Regulation of International Securities Markets" (November 14, 1988 Press Release).

2. The relevant releases are as follows: Securities Act Release No. 6838 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,426 (July 11,1989) reproposing Regulation S (hereinafter the "Reproposing Release"); Securities Act Release No. 6779 [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,242 (June 10, 1988), proposing Regulation S (hereinafter the "Proposing Release"); Securities Act Release No. 6839 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,427 (July 11, 1989), reproposing Rule 144A (hereinafter the "Rule 144A Reproposing Release"); Securities Act Release No. 6806 [1988-89 Transfer Binder] Fed. Sec. Law Rep. (CCH) ¶84,335 (Oct. 25, 1988), proposing Rule 144A (hereinafter the "Rule 144A Proposing Release"); Securities Exchange Act Release No. 27017 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,428 (July 11, 1989), adopting Rule 15a-6 relating to the registration of foreign securities dealers (hereinafter the "Rule 15a-6 Release"); Securities Act Release No. 6841 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,432 (July 24, 1989), relating to multi-jurisdictional disclosure (hereinafter the "Multi-Jurisdictional Disclosure Release").

the registration provisions of the Securities Act kept U.S. investors from purchasing securities of foreign issuers distributed outside of the United States. Foreign issuers for the most part were unwilling to offer their securities in the United States because of unwillingness (or inability) to comply with SEC registration requirements and accounting principles and fear of the potential "in terrorem" liabilities under Section 11 of the Securities Act for false or misleading statements in a registration statement. U.S. institutional investors, increasingly interested in the global diversification of their portfolios, were forced to buy foreign securities, if at all, in the secondary markets, often at premium prices above the original offering price. The broker-dealer registration provisions under the Exchange Act[3] also made it difficult for foreign securities firms to transact business in the secondary markets with prospective U.S. institutional investors.

The new focus of an energized staff has resulted in a plethora of proposals and reproposals, some aspects of which are controversial and most of which have not yet been adopted. The composition of the Commission is in transition, and although the new Commission is likely to favor the liberalization represented by the proposals, there may be additional delays and some changes as the new Commissioners familiarize themselves with the proposals and the new Chairman assumes a leadership role. The proposals include the following:

1. The centerpiece is proposed Regulation S regulating offshore distributions by U.S. and foreign issuers. Regulation S removes the threat of the long reach of the Securities Act registration provisions from most offshore distributions of straight debt securities by foreign issuers and from some offshore distributions of equity securities of foreign issuers, permitting U.S. investors to purchase them provided the transaction takes place offshore and there is no directed selling effort in the United States.[4] Regulation S also includes safe harbors for offshore distributions by U.S. issuers which liberalize the restrictions that the issuer was obligated to adopt under the no-action letter policies to prevent flowback of the securities to the United States. Regulation S also allows U.S. institutions to invest in any offshore offering by forming a non-U.S. subsidiary based offshore for the specific purpose of purchasing such securities[5] or by giving a foreign investment adviser discretion to purchase such securities for its account.[6]

2. Proposed Rule 144A is intended to provide an efficient, liquid market among large (portfolios with a cost basis of excess of $100 million) institutional investors for securities issued in exempt offerings (including Regulation S offshore distributions for this purpose as an exempt offer-

3. Securities Exchange Act, §15(a).
4. *See* §6[c] *infra*.
5. *See infra* note 77.
6. *See infra* note 85.

ing). Rule 144A has broad implications for exempt offerings by U.S. issuers in the United States, but will also operate in tandem with Regulation S in a number of important respects. The scenarios that will develop remain to be played out, but the opportunities are numerous including a private tranche of a Regulation S offering being made concurrently in the U.S. to qualified institutional investors. Although the private tranche will have to find an appropriate exemption from Section 5, the sale of securities in a closed system open only to Rule 144A purchasers makes it likely that such an exemption will be available. Rule 144A also enhances the liquidity for privately placed securities (and, hence, the attractiveness of the offering) and Rule 906 of Regulation S also provides an exit from the private market assuming that the securities are traded in an organized foreign securities market.[7] Rule 144A also provides liquidity (and an opportunity for qualified institutional investors to purchase) securities distributed offshore pursuant to Regulation S as the foreign purchaser could resell such securities during the Regulation S restricted period to a qualified institutional investor in reliance on Rule 144A. The Commission concurrently proposed to amend Rule 144(d)(1) so as to permit successive purchasers in a series of private transactions to tack the holding period of their predecessors back to the first purchase from the issuer (or an affiliate of the issuer).

The National Association of Securities Dealers (NASD) submitted a proposal to the Commission under which it would operate PORTAL, a screen based market limited to qualified institutional investors as defined by Rule 144A for both initial private placements and subsequent trading among qualified institutional investors.[8] The existence of such a market could increase significantly the liquidity of securities traded and may reduce or eliminate discounts incurred in the secondary market for restricted securities. PORTAL could also serve as a policing device to assure compliance with Rule 144A and to police the exit of the security from that market in compliance with applicable law. The promise of PORTAL is a more efficient and liquid secondary market in privately placed securities.[9] The American Stock Exchange is considering a similar closed market, SITUS, which would be limited to securities of foreign is-

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7. *See* §7[b] *infra*.

8. The NASD submitted a revised proposal to the Commission on November 3, 1989 for approval of PORTAL, an acronym for Private Offerings, Resales and Trading through Automated Linkage. The proposal, if approved, will become Schedule I to the NASD By-Laws. *See* Securities Exchange Act Release No. 27470, 54 Fed. Reg. 49164 (Nov. 29, 1989).

9. The NASD expects to have the system up and operating shortly after the adoption of Rule 144A and its proposal is subject to the adoption of Rule 144A. The system can be accessed only by qualified institutional investors (including securities dealers that qualify) and by securities dealers acting as brokers that meet minimum capital requirements established by the NASD and register as participants with the NASD. Access to the primary market will be by a personal computer and a modem; eventually, continuous access to the secondary market will be provided for participants in the system. *See* Wall Street Letter, Nov. 13, 1989, at 6 and Sept. 11, 1989, at 4. PORTAL is discussed further at §8[g].

suers.[10] A screen based market for privately placed securities could revolutionize the manner and extent to which such securities are traded and seems essential if Rule 144A is to live up to its promise.

3. The Commission proposed and adopted Rule 15a-6 providing a very limited exemption from the broker-dealer registration provisions for foreign broker-dealers transacting business with U.S. institutional investors. The Rule attempts to establish a territorial principle for the regulation of broker-dealers—broker-dealers confining their securities business offshore do not have to register with the SEC, whereas those conducting business in the United States do.[11] If, however, a foreign dealer chooses to conduct its U.S. business through a registered U.S. affiliate, as many of them do, such registration does not extend to the activities of personnel of their parent located outside of the United States. The parent would have to register with the Commission in order to conduct business directly in the United States.[12] In addition, a broker-dealer operating offshore, but soliciting transactions from U.S. investors in the United States by phone or otherwise is subject to the broker-dealer registration provisions. Rule 15a-6 is a very limited conditional exemption from this general scheme. A foreign broker-dealer may furnish research reports to major U.S. institutional investors under limited and restricted circumstances. The Rule also permits the direct solicitation of major and other institutional investors provided the transaction is effected through a registered U.S. dealer.[13] Such transactions, however, are subject to a number of restrictions which include, for institutional investors that are not in the major category, the participation of an associated person of a U.S. registered dealer in all oral conversations with the institutional investor.[14] A major institutional investor is one that has total assets of $100 million or more.[15] The Rule also permits a foreign broker-dealer to effect transactions with and solicit a registered broker or dealer, whether such registered broker-dealer is acting as principal or as agent, or a bank acting as a broker-dealer.[16] The restrictions and conditions of Rule 15a-6 are so numerous and onerous it is unlikely that they will dramatically affect the manner in which foreign broker-dealers sell securities to U.S. inves-

10. *See* Reproposing Release, *supra* note 2, at 80, 229 n. 42.

11. *See* Rule 15a-6 Release, *supra* note 2, at 80,237.

12. *Id.* As of 1987, there were 179 registered broker-dealers which were affiliated with foreign broker-dealers or foreign banks. *Id.* at 80,233. Foreign broker-dealers avoid registering the parent, as in that event the parent would have to become a member of the National Association of Securities Dealers and its personnel would have to meet the various requirements of the NASD for principals and registered representatives. The Commission, however, raises no objection to personnel who are subject to the supervision of the registered U.S. affiliate and have met the NASD (and/or other SRO) requirements from soliciting U.S. transactions while based at the office of the parent if the transactions are executed by the registered affiliate. *Id.* at 80,238.

13. Rule 15a-6(a)(2)-(4).

14. Rule 15a-6(a)(3)(iii)(B).

15. Rule 15a-6(4)

16. Rule 15a-6(a)(4).

tors or the manner in which U.S. institutional investors access the market for foreign securities. The Commission also issued a concept release which envisions the ultimate acceptance of home country regulation of broker-dealers based on common standards which would permit securities dealers to operate cross-borders subject primarily to regulation of the home state.[17] Such a proposal would require legislation and at the moment is only a concept.

4. The Commission has also proposed rules and forms relating to offerings by certain Canadian issuers in the United States reflecting an understanding with the Ontario and Quebec securities commissioners who have proposed counterpart procedures for U.S. issuers in their respective provinces. The resulting regimen could become the prototype for multinational offerings involving other jurisdictions with advanced disclosure systems. The civil liability provisions of the U.S. securities laws would remain applicable. The Commission's proposed rules and forms include the following:[18]

(a) A Form F-9 to be used by substantial Canadian issuers for offerings of investment grade non-convertible debt securities or non-convertible preferred stock. A substantial issuer eligible to use this form must have a total common stock market capitalization of at least (CN) $180 million and a public float of (CN) $75 million. The issuer would prepare disclosure documents in accordance with Canadian requirements and the review of those documents would be by Canadian authorities which would determine when the registration statement would become effective. A wraparound of the Canadian prospectus together with exhibits and copies of documents incorporated by reference would be filed as the Form F-9, and which would be given a "no review" status in all but exceptional situations. A Form F-X would also be filed which would include a consent to service of process, appointment of a U.S. person as agent for process, a consent to service of an administrative subpoena, and an undertaking to assist the SEC with administrative investigations. The disclosure documents used in the United States would be the Canadian disclosure documents which, however, would have to include statements warning that the investment could have tax consequences in the issuer's jurisdiction, that difficulties may be encountered in pursuing remedies for securities law violations against persons and assets located outside the United States, and that the financial statements were prepared in accordance with Canadian accounting standards.

(b) Form F-10 would be available for offerings by substantial issuers of securities other than investment grade debt or preferred stock. A substantial issuer eligible to use this form, however, must have a common stock market capitalization of at least (CN) $360 million and a public

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17. Securities Exchange Act Release No. 27,018 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,429 (July 11, 1989).

18. *See* Multi-Jurisdictional Disclosure Release, *supra* note 2.

float of (CN) $75 million. The registration and disclosure procedures would be the same as in a Form F-9 offering except there would have to be a reconciliation of financial statements to U.S. GAAP which requires, among other things, the segmental information and supplemental oil and gas data specified by Regulation S-X.

(c) Form F-7 would be available for rights offerings by certain Canadian issuers provided U.S. residents held of record less than twenty percent of the class of stock to which the offering pertained. To be eligible to use Form F-7, the Canadian issuer must have had a class of securities listed on the Toronto or Montreal Stock Exchange for the immediately preceding thirty-six months. The procedures would be substantially the same as those outlined in connection with Form F-9.

(d) Form F-8 would be used to register exchange offers by a Canadian issuer for a Canadian target if less than twenty percent of the securities of the target class are held of record by residents of the United States. To be eligible to use Form F-8, the Canadian issuer would have to have a common stock market capitalization of not less than (CN) $75 million and have had a class of securities listed on the Toronto or the Montreal Stock Exchange for the immediately preceding thirty-six months. The Canadian issuer would file the offering materials required under Canadian law with the SEC on Form F-8 accompanied by the Form F-X and the registration statement would become effective on filing with the Commission. Compliance with the tender offer regulations applicable in Canada would be deemed compliance with the Williams Act.

(e) The proposed regimen would also extend to tender offers for Canadian issuers which are Canadian reporting companies if less than twenty percent of the target's securities for which the bid is made are held of record by U.S. residents. In the case of a cash tender offer, the appropriate Canadian offering materials would be filed with the SEC under wraparound Schedules 14D1-F (for third party tender offers); Schedule 13E-4F (for issuer tender offers), and Schedule 14D9-F (for the target's response). Compliance with applicable Canadian requirements would be deemed compliance with the Williams Act provided the foregoing forms are filed with the SEC to the extent applicable and provided the tender offer is extended to all holders of the class of securities in the United States.

Regulation S and Rule 144A together promise to significantly change and liberalize offshore distributions and the access of U.S. institutional investors to foreign securities. Proposed Regulation S suffers from a number of ambiguities, necessitating a careful scrutiny of the Proposing and Reproposing Releases in an effort to clarify the nuances. Specifically, Regulation S does not say, except by implication, that a foreign purchaser who acquires the security sold in reliance on Regulation S can, after the end of the restricted period, sell the security to a U.S. person or in the

U.S.[19] The distinction between debt and equity securities is important in a number of contexts under Regulation S, but the Regulation does not make it clear whether convertible debentures are debt or equity securities, or both.[20] Regulation S also fails to provide that debt securities of a subsidiary guaranteed by a reporting company are to be treated as securities issued by a reporting company. The result will be to discourage the use of subsidiaries for offshore financing. Proposed Rule 144A and proposed amendments to Rule 144(d)(1) impose discriminatory non-national treatment in certain respects with respect to securities of non-reporting foreign issuers.[21] Clarification is needed in other areas as well.

The foregoing comments should not detract from the major contribution the adoption of Regulation S and Rule 144A will make to international capital markets. There undoubtedly will be some modifications in Regulation S and Rule 144A as adopted, reflecting the comments of the commenters and the views of the new Commissioners. Hopefully, not too much additional time will be spent attempting to fine tune the proposed rules in an effort to get it right the first time. Experience under the Regulation and Rule will provide ample opportunity for problems to surface which can be handled by amendments and/or interpretative releases, much as in the case of Rule 144. The complexity of the area and transactions that will be governed by Regulation S and Rule 144A is such that it is likely that the interpretative function will be an ongoing one for several years as the market reacts with different types of securities and marketing mechanisms.

The impetus for Regulation S and Rule 144A may have been to improve the access of institutional investors to securities distributed offshore, but from the standpoint of a securities practitioner it has tremendous importance for issuers distributing securities outside of the United States. The primary focus of this article is the application of the U.S. securities laws to offshore distributions. A U.S. issuer distributing securities offshore must deal with securities regulation in the countries in which it proposes to make the distribution; foreign securities regulation is discussed briefly, primarily to assure that it is not overlooked. The approach of this Article beyond that is two-fold: First, it takes a linear and long look in Part I at the regulatory scheme embraced in Regulation S and Rule 144A, viewing it in broad outline. Secondly, in Part II, it takes a cross-section look viewing separately the application of that scheme to discrete offshore distributions, and hybrid offshore-onshore distributions.

§2 FOREIGN SECURITIES REGULATION

Securities regulation in some form now exists in many countries with

19. *See* §7[c] *infra*.
20. *See* §9 *infra*.
21. *See* §8[d]-[e] *infra*.

free-market economies. In France,[22] Japan,[23] Italy,[24] Australia,[25] and Mexico[26] there are national commissions or bureaus which to a degree are a counterpart of the SEC. In Canada,[27] there are provincial commissioners who function very much like state blue-sky commissioners in the United States. Australia created a National Companies and Securities Commission, but to avoid constitutional questions the federal government adopted three principal laws relating to securities and corporations and each of the Australian states then adopted laws identical to the federal laws, administered in conjunction with the federal regulation.[28] In 1989, Australia adopted a Commonwealth Corporations Act creating the Australian Securities Commission which supplants the federal-state coordinated system of regulation with a federal system.[29] In the United Kingdom, the Financial Services Act of 1986 established a unique blend of securities regulation emphasizing the role of the Self-Regulatory Organizations, but supervised and monitored by the Securities and Investment Board, which is a government agency in all but name and legal formalities.[30] Hong Kong has a Securities Ordinance which establishes a Securities Commission, provides for a Securities Commissioner and an extensive system of securities regulation[31] which is being replaced by a new scheme because of its inability to cope with the October 1987 stock market collapse.[32] In other countries, including Germany,[33] the Netherlands,[34] Belgium,[35] and Luxembourg,[36] the stock exchanges are the principal

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22. *See* G. Miller, *Securities Regulation in France*, in INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION (H. Bloomenthal ed.) (hereinafter "ICMSR"), at ch. 7.

23. *See* M. Tatsuta, *Securities Regulation in Japan*, in ICMSR, at ch. 11.

24. *See* ICMSR, at 1-60.

25. *See* J.P. Hambrook, *Securities Regulation in Australia*, in ICMSR, at ch. 10.

26. *See* ICMSR, at 1-67.

27. *See* J. Cowan, *Securities Regulation in Canada*, in ICMSR, at ch. 4.

28. *See* Hambrook, *supra* note 4, at §10.01.

29. *See* 2 International Securities Regulation Rep. (BNA), at 2-3 (Nov. 8, 1989). The Act is being challenged on constitutional grounds and the issue is expected to be resolved by the High Court during early 1990. *Id.*

30. *See* H. Bloomenthal, *United Kingdom—Financial Services Act*, in ICMSR, at ch. 6A.

31. *See* T. Rogers, *Securities Regulation in Hong Kong*, in ICMSR, at ch. 12.

32. *See* ICMSR, at 1-64.

33. *See* E. Röhm, *Securities Regulation in Germany*, in ICMSR, at ch. 8C.

34. *See* J. Schaafsma, *Securities Regulation in the Netherlands*, in ICMSR, at ch. 8. In February of 1989, the Securities Board of the Netherlands, a self-regulatory organization modeled loosely after the scheme of regulation in effect in the United Kingdom, assumed responsibility for supervising the stock exchanges, the over-the-counter market, and Dutch laws impacting securities generally. The board has the power to advise, to adopt binding interpretations and to persuade, but not the power to impose sanctions. *See* Raun, *Start By Dutch Watchdog*, Fin. Times, February 1, 1989, at 33.

35. *See* E. Wymeersch, *Securities Regulation in Belgium*, in ICMSR, at ch. 8A. In Belgium, an issuer publicly offering securities has to file a prospectus with the Banking Commission. *Id.* at §8A.05.

36. *See* E. Wymeersch, *Securities Regulation in Luxembourg*, in ICMSR, at ch. 8B. In Luxembourg, an issuer must register securities with the Institute Monetaire before securi-

source of securities regulation, and in all countries with stock exchanges, such exchanges play a role as a self-regulatory agency which often extends beyond that played by American stock exchanges.

To the extent securities regulation exist outside the United States, emphasis is placed on disclosure in connection with public offerings, stock exchange listings and annual and semi-annual reports to shareholders.[37] There is also a significant consensus as to the need for regulation of investment companies,[38] securities dealers,[39] insider trading,[40] and, to a lesser degree, takeovers.[41] There is little regulation of proxy solicitation outside the United States and Canada.[42] There is obviously considerable variation in the content of regulation and the means of enforcement with only the United States placing considerable reliance on private remedies, although the United Kingdom, in particular, has in place civil remedies that might become the basis for effective enforcement through private actions.[43] In the disclosure area, the European Economic Community has

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ties can be offered publicly. *Id.*

37. *See* ICMSR, at §1.08[2]-[3]. In the European Community, the directives relating to prospectus disclosure requirements (which are presently confined to securities to be listed upon completion of a public offering and to listing applications) will become all pervasive under a directive relating to the distribution of a prospectus when transferable securities are offered to the public. Directive No. 89/298, O.J. 1989 L124/8; Common Mkt Rep. (CCH) ¶1751. Member states must adopt conforming legislation by April 17, 1991.

38. *See* ICMSR at §1.09.

39. *Id.* at §1.04. The European Community is moving toward a single financial services market by the end of 1992 based on the principle that an entity authorized to conduct various aspects of the investment business in its home state can operate in any member state. The basis for this scheme of regulation can be found in the proposed Second Banking Coordination Directive, the proposed Investment Services Directive, and other related directives. *See generally* Buchan, *EC Drafts Free Market Securities Directive*, Fin. Times, Dec. 15, 1988. The Second Banking Directive proposed by the Commission in December of 1988 (O.J. 1988 C84/1; Common Mkt. Rep. (CCH) ¶95,028) was revised by the Commission in April of 1989 (Common Mkt. Rep. (CCH) ¶95,113) and must be approved by the Council and EC Parliament. The investment services proposal ((COM(88) 778); Common Mkt. Rep. (CCH) ¶95,028) also requires the approval of the Council and Parliament.

40. *See* ICMSR, at §1.08[5].

41. *Id.* at §1.08[6]. Such regulation will become pervasive if the Thirteenth Company Law Directive on Take-over and Other General Bids becomes effective. The Directive was approved by the Commission (O.J. 1989 C64/8; Common Mkt. Rep. (CCH) ¶60,200) but must complete the EC's legislative process.

42. *Id.* at §1.08[7].

43. The Financial Services Act ("FSA") provides that a purchaser of a security can bring an action based on a false or misleading statement in a prospectus or listing particulars. FSA §§150, 166. The FSA also provides that any person injured as the result of a violation by a member of any rule of a self-regulatory organization can bring a private action against such member. FSA §62(2). The lack of a class action counterpart in the U.K. and other countries probably plays a role in the reluctance of private parties to initiate litigation. The U.K. courts have been innovative in allowing master pleadings to facilitate actions by multiple plaintiffs with similar claims, selecting lead cases to resolve issues common to such claims, and providing for sharing of costs among multiple plaintiffs pending resolution of the case and determination of who is to bear the costs. *See* Davies v. Eli Lilly & Co., 131 Sol. J. 807 (Q.B. 1987), 3 All E.R. 94 (C.A. 1987), 1 W.L.R. 1136 (1987).

taken a number of steps and is considering others to establish minimum and relatively uniform standards among the twelve nations that are members of the Community.[44]

§3 OFFSHORE DISTRIBUTIONS AND RELEASE 4708

U.S. issuers raise substantial amounts of capital in the Eurocurrency markets.[45] These issues are typically debt issues (occasionally convertible debt) by well established companies undertaking financing through a subsidiary. The offerings are generally listed on an exchange (usually Luxembourg or London) which necessitates compliance with the appropriate listing requirements, but otherwise are not regulated based on the widely accepted "fiction" that they are exempt private placements.[46] The offerings are typically syndicated, often with the international subsidiary of a U.S. investment banking firm as the lead underwriter. A U.S.-type prospectus is typically used, although the securities are generally not registered with the Securities and Exchange Commission. Significant amounts of monies have been raised outside the U.S. by less established issuers generally in private placements, but in some instances through public offerings, particularly in the United Kingdom since the establishment of the Unlisted Securities Market under the auspices of the International (London) Stock Exchange.[47]

The Securities and Exchange Commission adopted Release 4708 in 1964 to facilitate distributions made outside the United States by U.S. issuers.[48] The Commission in Release 4708 announced that it would take no action for failure to register under the Securities Act securities offered outside the United States exclusively to foreign nationals so long as "the distribution is to be effected in a manner which will result in the securities coming to rest abroad."[49] For over twenty-five years, distributions were made outside the United States in reliance on Release No. 4708. Various techniques were employed to provide assurance that the securities were sold only to non-nationals of the United States and were not redistributed in the United States. The principal arrangement used in connection with the sale of Eurobonds was to lock them up for 90 days by agreements among the underwriters and dealers not to offer or sell the securities to U.S. nationals; the issuance of a global certificate for the en-

44. *See* ICMSR, at §1.01[2], §1.08[3], §1.09[2].

45. During 1988, Eurobond issues aggregated $180.9 billion of which $72.1 billion was denominated in dollars. INSTITUTIONAL INVESTOR (int. ed.), Feb., 1989, at 125-30. These were not all by U.S. issuers, although a significant part represented offerings by U.S. issuers. *See* ICMSR, at §1.02[3].

46. On Eurobond issues generally, see A. Pergam, *Eurocurrency Financing*, in ICMSR, at ch. 9.

47. Fourteen U.S. issuers went public on the Unlisted Securities Market in 1986. *See Low Costs Attract*, Fin. Times, Jan. 20, 1987.

48. Registration of Foreign Offerings by Domestic Issuers, Securities Act Release No. 4708, Fed. Sec. L. Rep. (CCH) ¶1361-1363 (July 9, 1964).

49. *Id.* at 2124.

tire issue, the purchasers receiving only an interim receipt that could be exchanged at the end of 90 days for a certificate. To receive such certificate, the purchaser has to certify that he is not a national of the United States and has not purchased the securities for a national of the United States.[50] The Commission excluded distributions made in Canada from Release 4708. It was commonplace, therefore, in connection with Eurobond issues, to extend the lock-up provisions to sales made in North America or to North American purchasers.[51]

Although the lock-up procedures relating to non-convertible debt securities were well established, it was less certain as to what the staff would deem appropriate in connection with an offshore distribution of equity securities, including convertible debt, particularly as to the status of the securities after the expiration of the lock-up period. In 1985, the staff issued a no-action letter which clarified and liberalized the procedures relating to a distribution outside the United States of equity securities.[52] The procedures included (1) an undertaking by the underwriter not to offer the shares in the United States or Canada or to North American persons for twelve months following completion of the offering; (2) a conspicuous statement on the cover page of the prospectus that (a) the securities were not registered under the Securities Act, (b) could not be offered or sold in North America or to North American persons during such twelve-month period, and (c) then only (i) pursuant to an exemption from registration, or (ii) if registered, or (iii) if sold on the Stock Exchange in London; (3) a restriction on transfer for twelve months to North American persons; (4) a legend on the stock certificates issued in connection with the offering and during the restricted period reflecting the conditions; and (5) prior to any transfer purchaser had to certify that he agreed to such conditions and was not a North American person or acquiring the shares for any such person. *InfraRed* represented a liberalization of prior staff positions in that it accepted sales on a foreign stock exchange after the expiration of the restricted period as an appropriate alternative for reselling the securities acquired in the distribution.

§4 DISTRIBUTIONS PURSUANT TO REGULATION S—INTRODUCTION

In June of 1988, almost twenty-four years after the issuance of Release 4708, the SEC revisited Release 4708 and proposed to replace it with Regulation S.[53] In July of 1989, Regulation S was reproposed with a

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50. *See, e.g.*, Procter & Gamble Co., SEC No-Action Letter (Feb. 21, 1985).

51. The Proposing Release relating to Regulation S makes it clear, whether or not Regulation S is adopted, that the Commission has abandoned the qualification made in Release 4708 that the Release was not applicable to distributions made in Canada. Henceforth, distributions in Canada are to be treated on the same basis as other distributions made outside of the United States. See *infra* note 116.

52. InfraRed Associates, Inc., SEC No-Action Letter (Oct. 14, 1985).

53. Proposing Release, *supra* note 2. The Staff will not issue interpretative or no-action letters under Release 4708 until the Commission acts on proposed Regulation S. *Id.* at 89,130.

number of revisions[54] and its adoption in some form is imminent. Regulation S should facilitate offshore distributions by U.S. issuers and also will provide assurance that the long arm of the Securities Act registration provisions generally do not reach offerings made by foreign issuers outside the United States. Regulation S will also redefine a U.S. person so that the registration provisions of the Securities Act will no longer protect U.S. citizens residing outside the United States who purchase securities outside the United States and will permit U.S. institutional investors to organize a foreign affiliate for the express purpose of purchasing foreign issued securities outside the United States.[55] A Note to proposed Regulation S and the proposing Release stresses that Regulation S is applicable only to the registration provisions of the Securities Act and in no way limits the application of the anti-fraud provisions of the Securities Acts.[56] Regulation S also is not applicable to securities issued by a registered investment company, which have to continue to register securities distributed outside the United States.[57]

The Proposing Release refers to Regulation S as embodying a "territorial approach" in contrast to Release 4708 which was concerned with protecting U.S. investors. This is largely true as to securities issued by foreign issuers at least to the extent that they remain offshore for trading purposes. The principal difference in this respect, however, as to U.S. investors, is the new definition of U.S. persons. Insofar as individuals are concerned, it is probably of no great moment as it is doubtful if U.S. citizens residing outside the United States play an important role as investors in offshore capital markets.[58] It will, however, make a major difference for U.S. institutional investors which have affiliates organized under foreign laws, since such affiliates will not be deemed U.S. persons[59]

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54. Reproposing Release, *supra* note 2.

55. Rule 902(i).

56. Regulation S, Preliminary Note 1. The Proposing Release stressed that "the U.S. anti-fraud provisions should be broadly interpreted to rectify the damage suffered as a result of any fraudulent conduct." Proposing Release, *supra* note 2, at 89,129. On the extraterritorial application of the fraud provisions, see §11. Regulation S, of course, has no application to the blue-sky laws. Regulation S, Preliminary Note 4.

57. Rule 901(c).

58. Although Regulation S does not deal specifically with the issue and literally appears to put military personnel on permanent duty status outside of the United States outside the protection afforded by Securities Act registration for securities other than securities of registered investment companies, a footnote to the Proposing Release advises this may not always be the case, stating: "[O]fferings specifically targeted at identifiable groups of U.S. citizens abroad, such as members of the armed forces serving overseas, would be deemed made within the United States." Proposing Release, *supra* note 2, at 89,135 n.106. The critical term appears to be "targeted" and seems to have in mind the infamous activities of Investors Overseas Services which although selling to others offshore initially was heavily aimed at U.S. military personnel. *See* C. RAW, B. PAGE, AND G. HODGSON, DO YOU SINCERELY WANT TO BE RICH? (1971), at ch. 4. Compare the issue of residence of military personnel for purposes of Rule 147. *See* H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW (1989 ed.)[hereinafter "SFCL"] at §4.04[4].

59. Rule 902(i)(1).

even if organized for the specific purpose of purchasing foreign securities. Such institutional investors will, in effect, have elected to be governed by the laws of the country in which the offering is made insofar as registration of the securities is concerned, provided the transaction takes place outside the United States.

Regulation S does not specifically deal with one of the more troublesome aspects of Release 4708 and that is when the securities can be resold in the United States. Rule 906 is a resale provision, but it is limited to resales outside the United States. Although no mention is made of this fact in the Reproposing release, without any fanfare the revised proposed Regulation S includes Preliminary Note 6 which states that securities acquired "pursuant to Regulation S may be resold in the United States only if they are registered under the Act or an exemption from registration is available." This issue is discussed below at §7[c]. Proposed Regulation S is loosely drawn in a number of other respects and requires reference to the Proposing Release and Reproposing Release[60] to fully appreciate how it will operate in a number of situations.

§5 The General Statement (Non-Safe Harbor) Approach

Regulation S sets forth a General Statement that offers and sales "that occur outside the United States" are not deemed an offer or sale for purposes of the registration provisions (Section 5) of the Securities Act.[61] If a transaction is within the scope of the General Statement, registration under the Securities Act is not necessary. For a transaction to qualify under the General Statement, both the sale and offer pursuant to which it was made must be outside the U.S..[62] Rule 901(b) sets forth a number of "relevant considerations," several of which are further defined in Rule 902, which are to be taken into account in determining whether offers or sales occur outside the United States. If the offers and sales meet these general considerations, the offering is deemed to have occurred outside the United States. Regulation S, however, also contains some non-exclusive specific safe harbors[63] which, if relied upon, assure that the offering will be deemed to have occurred outside the United States. Most issuers, presumably, will rely on one of the safe harbors and will fall back on the general provisions if there is inadvertent noncompliance with some aspect of the safe harbor. The General Statement provisions and definitions to some degree recur in the specific safe harbors and to this extent are also relevant.

Under the General Statement approach, relevant considerations in determining whether an offer and sale occurs outside the United States

60. *See supra* note 2.

61. Rule 901.

62. Rule 901(a).

63. Rules 903 through 906 "set forth non-exclusive safe harbors for extraterritorial sales and resales of securities." Proposing Release, *supra* note 2, at 89,133.

include the following:

1. The locus of the constituent elements of the offer or sale.[64] The following factors are indicative that the offer and sale took place outside the United States:

a. Offers are directed only to persons outside the United States.

b. Buy orders originate outside the United States by buyers who are outside the United States.

c. Execution of the transaction, payment and delivery take place outside the United States. Payment into or from the U.S., however, would not necessarily indicate that a transaction took place in the U.S., but payment from and to a foreign location could, in combination with other indicia of a foreign transaction, lend weight to finding the transaction to be outside the United States.[65]

d. The sale is executed on or through the facilities of an established foreign securities exchange or designated organized foreign securities market.

2. There is no directed selling effort in the United States. Directed selling relates to efforts to condition the market in the United States for securities being offered pursuant to Regulation S.[66] "The presence of directed selling efforts in the United States would generally lead the Commission to find that the transaction occurred within the United States."[67] The concept of "directed selling efforts" is also relevant to the general conditions applicable to all the safe harbors and is discussed further below at §6[b].

3. The securities have come to rest outside the United States. This is, of course, the critical concept. The proposing Release has a general statement which makes it sound deceptively simple: "Generally, securities would be considered to have come to rest abroad if the distribution has been completed and resales into the United States are only made in routine trading transactions."[68] The Rule[69] includes a number of considerations to be taken into account in determining the likelihood that the securities have come to rest outside the United States:

a. The nationality of the issuer. There is a greater likelihood of the securities remaining outside the United States in an offering made abroad by a foreign issuer, the securities of which has no U.S. market interest, than in an offering by a U.S. issuer.[70]

b. The extent of the issuer's business presence in the United States.

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64. Rule 901(b)(1).
65. Proposing Release, *supra* note 2, at 89,131.
66. Rule 902(b).
67. Proposing Release, *supra* note 2, at 89,131.
68. *Id.* at 89,132.
69. Rule 901(b)(3).
70. Proposing Release, *supra* note 2, at 89,132.

c. The type of security being offered. Equity securities are more likely to flow back to the home country or primary market after distribution than debt securities.[71]

d. The absence of a substantial U.S. market interest in the securities of the issuer. A trading market in U.S. implies a demand for the securities on the part of U.S. investors, particularly if the securities offered abroad are of the same class as those traded.[72]

e. The contractual or other provisions restricting the resale of securities into the United States and to U.S. persons. This provision invites a do-it-yourself type of lock-up to prevent sales to U.S. persons and to prevent flowback. In fact, most issuers are likely to rely on the applicable safe harbors discussed below.

4. The justified expectations of the parties as to whether the U.S. registration provisions are applicable. A U.S. national who effects transactions in foreign securities markets under appropriate circumstances may be relying on the laws of the country in which the securities are being marketed or traded. The parties may adopt choice of law provisions to make this clear.[73] A choice of law provision, however, undoubtedly would not be controlling as to sales made in the United States or to U.S. persons as part of a distribution.

§6 THE SAFE HARBORS

[a] Introduction—Definition of a U.S. Person

The provisions of the General Statement that are obviously difficult to apply are those relating to whether or not the securities are likely to come to rest outside the United States. Since the safe harbor provisions deal extensively with this area, compliance with Rule 903, which provides that a distribution which satisfies the conditions of Rule 904 thorough 906 shall be deemed to occur outside the United States, is likely to be the choice of most issuers. The safe harbor provisions distinguish between sales made by the issuer and the distributors (underwriters and dealers, primarily) and their affiliates on the one hand and everyone else (the investors who purchase the issue).[74] The safe harbors attempt to assure that the offering is distributed outside the United States and the securities come to rest outside the United States by imposing on the issuer and

71. *Id.* at 89,133.

72. *Id.*

73. *Id.*

74. The Commission's releases refer to two safe harbors—one for issuers and securities professionals involved in the distribution process and their affiliates (the "issuer safe harbor") and the other for resales by other persons (the "resale safe harbor"). *See* Reproposing Release, *supra* note 2, at 80,209. The issuer safe harbor is then divided into three separate categories. For exposition purposes in these materials the three separate categories are treated as three separate safe harbors and resales are discussed separately as part of a larger problem of resales offshore and resales in the U.S. or to U.S. persons.

distributor offering restrictions and transaction restrictions and imposing on the investors transaction restrictions. The offering restrictions, if applicable, always follow the same general format. The transaction restrictions, both as to nature and duration, depend upon the nature of the issuer, the type of security, and who is the seller. There are also certain general conditions that must be complied with in connection with all the safe harbors.

The concept of a U.S. person plays an important role in all safe harbor contexts except a distribution by certain foreign issuers. The concept of a U.S. person is concerned with purchasers rather than issuers of securities. Under Regulation S, U.S. persons, in a departure from old concepts, as to any natural person means a "person resident in the United States."[75] Thus, the appropriate consideration is residence rather than citizenship; a U.S. citizen who is a resident of France is not a U.S. person and a French citizen who is a resident of the United States is a U.S. person. A corporation or partnership organized under the laws of the United States is a U.S. person. An agency or branch of a U.S. entity, however, is not a U.S. person if it operates for valid business reasons and not for the purpose of investing in unregistered securities *and* is engaged in the business of banking or insurance which subjects it to substantive banking or insurance regulation in the country in which it operates.[76] Any U.S. entity can organize a corporation under the laws of another country even if for the purpose of purchasing securities and not be deemed a U.S. person.[77] A branch or agency of a foreign entity is treated as a U.S. person if it is located in the United States.[78] An estate or trust in which any executor, administrator or trustee is a U.S. person and a non-discretionary custodial account or similar account held by a dealer or other fiduciary for the account of a U.S. person are U.S. persons.[79] A discretionary custodial account or similar account held by a dealer or other fiduciary located in the United States is a U.S. person unless held for a non-U.S. person in which event it is a non-U.S. person.[80] Regulation S as initially proposed would have overturned a previous no-action letter to the effect that a U.S. broker-dealer with discretion to act for a non-U.S. person would be a non-U.S. person when acting in that capacity.[81] After receiving comments, the Commission revised proposed Regulation S to be consistent with *Baer*.[82]

The fact that a discretionary account managed by a U.S. broker-dealer or investment adviser for a non-U.S. person is a non-U.S. person, however, does not readily permit the U.S. broker-dealer or investment

75. Rule 902(m)(1).
76. Rule 902(m)(3).
77. *See* Reproposing Release, *supra* note 2, at 80,217.
78. Rule 902(m)(1).
79. *Id.*
80. Rule 902(m)(1)-(2).
81. *See* Baer Securities Corp, SEC No-Action Letter (Oct. 12, 1979).
82. *See* Reproposing Release, *supra* note 2, at 80,217-18.

adviser to purchase securities distributed pursuant to Regulation S for its foreign clients if it does not maintain some type of office offshore. All of the Regulation S safe harbors require that the transaction be offshore which requires, among other things, that the broker-dealer or investment adviser be offshore at the time it receives the offer.[83] For the same reason, U.S. persons who are permitted to purchase securities of foreign issuers under certain circumstances pursuant to Regulation S (e.g., if issued in reliance on the category 1 safe harbor) will have difficulty in effecting a transaction offshore without maintaining an offshore presence. It cannot appoint a foreign agent to receive offers for it.[84] It could participate in such distributions by establishing a discretionary account with a foreign broker-dealer or investment adviser,[85] but would lose the ability to determine the securities to be purchased. U.S. institutional investors which are qualified institutional investors under Rule 144A will be able to purchase securities distributed offshore in the secondary market, but will have difficulty in becoming aware of such opportunities unless the security makes its way into a U.S. trading system, such as the NASD's proposed PORTAL Market.[86] A foreign broker-dealer could recommend the securities under very restricted circumstances in accordance with Rule 15a-6 without being registered as a broker-dealer, but the transaction would have to be executed by a registered broker-dealer.[87] A foreign broker-dealer with a U.S. affiliate that is registered may find it practicable to engage in such transactions, but Rule 15a-6 will discourage most others from soliciting such business. If the security is traded on a foreign stock exchange or in a designated organized foreign securities market, any U.S. person could purchase securities distributed pursuant to Regulation S in such market. If, however, the seller or the broker acting on its behalf knows that the transaction has been pre-arranged with a buyer in the United States, it will not be deemed an offshore transaction.[88]

The fact that transactions are effected on a foreign stock exchange has significance in a variety of contexts under the Regulation.[89] Foreign stock exchanges, unlike U.S. exchanges, trade a number of securities in various categories that are not technically listed, but, nonetheless, are traded under the auspices of the exchange. In recognition of this fact Regulation S introduces the concept of a "Designated Organized Foreign Securities Market" ("DOFSM") and generally treats such markets like an established foreign stock exchange for purposes of the Regulation. A Des-

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83. *See* §6[b] *infra.*

84. *See infra* note 95.

85. This follows from the fact that such foreign entity would be a non-U.S. person. The provision that a discretionary account held for a foreign person in the United States is a non-U.S. person operates in only one direction; there is no counterpart that a discretionary account held offshore for a U.S. person is a U.S. person. *See* Rule 902(m)(1)-(2).

86. *See* §8[g] *infra.*

87. *See supra* note 14.

88. Rule 902(g)(2).

89. *See*, for example, the discussion of resales under Rule 906 at §7[a].

ignated Organized Foreign Securities Market is one established under foreign law, has an established operating history, is subject to oversight by a governmental or self-regulatory body to which transactions are reported on a regular basis, and is designated so by the Division of Corporation Finance.[90] The Reproposing Release refers to the Association of International Bond Dealers, which regulates trading in Eurobonds, and the Unlisted Securities Market ("USM"), which is regulated by the International Stock Exchange in London, as two markets which would meet such criteria.[91]

[b] General Conditions

The safe harbors for issuers and distributors are divided into three categories which are distinguished by the offering and transaction restrictions imposed. All three categories, however, must comply with the same two general conditions:

1. The offers and sales must be made in an offshore transaction.[92] To be an offshore transaction:[93]

a. The offer must be made outside the United States.

b. The seller must reasonably believe that the buyer is outside the U.S. at the time the order is originated.

c. Execution and delivery must take place outside the U.S.

If, however, the transaction is executed on or through the facilities of an established foreign securities exchange or a designated organized foreign securities market, and is not pre-arranged by persons in the United States, the related offer must be made outside of the United States, but the buyer does not have to be outside the United States at the time the order is originated and the securities do not have to be delivered outside the United States.[94] The requirement as to a natural person is that the offer be made to the buyer himself outside the United States; it is not sufficient that it be made to his agent outside the United States.[95] Unsolicited buy orders transmitted from the United States and received by dealers outside the United States are not "offshore."[96] To be effected on a foreign exchange or designated securities market, the sale must be executed outside the United States by or through a member of the exchange and under the auspices of the exchange.[97]

2. There can be no directed selling effort in the United States in connection with the offering. Directed selling effort includes any activity un-

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90. Rule 902(a).
91. Reproposing Release, *supra* note 2, at 80,211 n.24.
92. Rule 904(a).
93. Rule 902(g).
94. *Id.*
95. Proposing Release, *supra* note 2, at 89,134.
96. *Id.*
97. *Id.*

dertaken by the issuer, the distributor, a seller, or an affiliate of any of them that could reasonably be expected "to have the effect of, conditioning the market in the United States for any of the securities being offered" under Regulation S.[98] It does not preclude product advertising and routine corporate communications (including press releases relating to financial results or material developments) unrelated to a selling effort, provided there is no reference to the offering of securities.[99] The Reproposing Release attempts to make it clear that an isolated, limited contact with the U.S. would not destroy the availability of the safe harbor under the "conditioning the market" standard.[100] The Rule specifically precludes an advertisement relating to the offering being placed in a publication "with a general circulation in the United States."[101] A publication with a general circulation is one that is printed in the U.S. primarily for distribution in the U.S.; or has had during the preceding twelve months an average circulation in the U.S. of 15,000 or more; or during the preceding twelve months has had an average of fifty percent or more of its circulation in the United States.[102] The 15,000 threshold was selected to separate out publications which produce a separate edition for distribution in the United States. In such event, if the affiliated non-U.S. edition does not meet this criterion, the advertisement can appear in the home publication provided it does not appear in the U.S. publication.[103] In any event, a publication necessary to meet the requirements of foreign law and not including anything more than is legally required will not be deemed a directed selling effort.[104] "The presence of directed selling efforts in the United States would generally lead the Commission to find that the transaction occurred within the United States."[105] On its face, this would appear to preclude a concurrent registered or Regulation D offering in the United States. The proposing Release, however, assures that this is not the case, stating: "Legitimate selling activities carried out in the U.S. in connection with an offering of securities registered under the Securities Act or exempt from registration . . . would not constitute directed selling efforts with respect to offers and sales made under Regulation S."[106] Unlike some of the other conditions of the safe harbors, failure to comply with this condition makes the safe harbor unavailable for

98. Rule 902(b).

99. Proposing Release, *supra* note 2, at 89,131-32; Reproposing Release, *supra* note 2, at 80,210-11. Compare the similar situation in connection with a domestic offering once the issuer is in registration. *See* SFCL, *supra* note 58, §6.09[3].

100. Reproposing Release, *supra* note 2, at 80,210.

101. Rule 902(b)(1).

102. Rule 902(i).

103. Reproposing release, *supra* note 2, at 80,211.

104. Rule 902(b)(2).

105. Proposing Release, *supra* note 2, at 89,131.

106. *Id.* The Proposing Release also states: "[I]t is the general view [of the staff] that exempt or registered domestic offerings and offshore offerings meeting the conditions of the proposed rules should not be integrated." *Id.* at 89,126.

the entire offering.[107]

[c] Category 1—Certain Foreign Issuers

An offshore distribution can be made by certain foreign issuers without any restrictions other than the general conditions. Issues in this category include a distribution by any foreign issuer of any security if there is no substantial U.S. market interest ("SUSMI") in the class of securities to be offered or sold, if equity securities are offered or sold, or no substantial U.S. market interest in any of its debt securities, if debt securities are offered or sold.[108] An "overseas domestic offering" ("ODO") by any foreign issuer is also in category 1 without regard to whether there is a SUSMI.[109] A foreign issuer is one incorporated or organized under the laws of a foreign jurisdiction. However, an issuer is not a foreign issuer if fifty percent of its outstanding voting securities are held by persons with a U.S. address *and* any of the following factors are present: (a) more than fifty percent of the assets of the issuer are located in the United States; (b) the business of the issuer is administered principally in the United States; or (c) the majority of the executive officers *or* directors are U.S. citizens or residents.[110] An issuer organized under the laws of the United States is not a foreign issuer even if 100% of its stock is owned by non-U.S. citizens or residents. Query whether the sale of stock by a foreign issuer, the proceeds from which are to be invested in a wholly owned U.S. subsidiary, would be deemed a technical compliance to which Regulation S would not provide a safe harbor under Preliminary Note 2 because it is a scheme to avoid the registration provisions.[111]

Regulation S includes specific criteria for determining whether there is a substantial U.S. market interest ("SUSMI") in a security. There is a SUSMI unless "it can be established" that (1) fifty percent of all recorded trades in an equity security during the prior fiscal year occurred on or through the facilities of established foreign securities exchange or designated organized foreign securities market *or* (2) that less than twenty percent of all recorded trading in the class of securities in the prior fiscal year occurred in he U.S. organized securities markets *and* the U.S. trading did not constitute the largest single market for such securities.[112] This places a substantial burden on the issuer and distributors to show there is no SUSMI. If debt securities are offered, the criteria are based on all of the issuer's debt securities, not merely those in the same

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107. Reproposing Release, *supra* note 2, at 80,218.

108. Rule 905(a)(1).

109. Rule 905(a)(2.

110. Rule 902(e).

111. *Cf.* Rule 140 which provides that an issuer which offers its securities for the purpose of purchasing the securities of another issuer is regarded as being engaged in the distribution of the securities of the other issuer for the purpose of defining an underwriter under Section 2(11) of the Securities Act.

112. Rule 902(l)(1).

class. There is a SUSMI unless "it can be established" that debt securities of the issuer are held of record by fewer than 300 U.S. persons *or* that less than $1 billion of the principal amount of its debt securities is held of record by U.S. persons.[113]

An "overseas domestic offering" (ODO) is defined to include an offering by a foreign issuer "directed either to citizens or residents of the issuer's jurisdiction of incorporation or organization" and made "in accordance with customary local practices and documentation."[114] The definition does not elucidate on what part of the offering must be sold in the issuer's home country to qualify although apparently it is intended to embrace offerings primarily, if not exclusively, sold in such jurisdiction. The Reproposing Release distinguished such offering from a multijurisdictional offering and noted that if "a substantial portion of the offering would be immediately resold outside the domestic market," it would not conform with the definition.[115]

The Proposing Release makes it clear, whether or not Regulation S is adopted, that the Commission has abandoned the qualification made in Release 4708 that it (the Release) was not applicable to distributions made in Canada. Henceforth, distributions in Canada are to be treated on the same basis as other distributions made outside the United States.[116] The prior concern was that the Canadian offering might be a conduit for a distribution in the United States. The absence of a "substantial U.S. market interest" and the restrictions on directed selling efforts in the U.S. are intended to deal with this problem. The Proposing Release qualifies the safe harbor by noting that "trading of a substantial amount of such securities in the United States shortly after they had been offered overseas would indicate a plan or scheme to evade the registration provisions,"[117] and Preliminary Note 2 to Regulation S provides that the Regulation is not available notwithstanding technical compliance if the transaction is part of a plan or scheme to evade the registration provisions.

The category 1 safe harbor for a distribution by certain foreign issuers is unique in certain respects, including the following:

1. It does not preclude the sale of such issue to a U.S. person who is in the country in which the distribution is made and buys the security while in the country. The general conditions described above[118] preclude an offer from being made in the United States and a directed selling effort in the United States. They do not preclude a sale to U.S. persons if

113. Rule 902(l)(2). Commercial paper exempt under Section 3(a)(3) of the Securities Act is included in making such determination, but if such securities are the only securities that would otherwise result in such determination the issuer does not have a SUSMI. Rule 902(l)(3).

114. Rule 902(h).

115. Reproposing Release, *supra* note 2, at 80,214-15.

116. Proposing Release, *supra* note 2, at 89,129 n.64.

117. Proposing Release, *supra* note 2, at 89,136.

118. *See* §6[b].

the offer and sale take place outside the United States. Restrictions on sales to U.S. persons are found in the transaction restrictions and, as is discussed below, transfer restrictions are not applicable to a distribution of securities of such a foreign issuer.

2. Neither the issuer nor the distributor has to adopt any offering or transaction restrictions. There may be a "catch-22," however, since a distribution in Canada, for example, may result, if there are no restrictions on resales to U.S. persons, in an immediate market developing in the United States and the contention could be made that there was a scheme to evade the registration provisions.[119] In an ODO, which most Canadian offerings would be, there may be SUSMI, in which event immediate resales in the United States markets appears likely. If the Commission adopts proposed Forms F-10 and F-9 for certain Canadian issuers, such issuers may consider registering the offering in the United States.[120]

Notwithstanding the fact that once the distribution is completed there is no specific restriction on resales in the United States, the combined effect of Sections 4(1) and 4(3) may preclude any dealer from selling the security without registration or an appropriate exemption in the United States for forty days.[121] Since it is relatively difficult to complete an offshore transaction with a U.S. person,[122] the advantages of category 1 are meaningful primarily because the absence of offering restrictions eliminates some of the inefficiencies of a category 2 offering and, in the context of an ODO of equity securities by a non-reporting foreign issuer with SUSMI, it avoids the onerous category 3 restrictions.[123]

[d] Offering Restrictions

Securities of all issuers other than category 1 issuers sold in reliance on a Regulation S safe harbor are subject to offering and transaction restrictions imposed on the issuer, the distributors and affiliates of the issuer and distributors and to transaction restrictions imposed on the investor-purchasers. The offering restrictions are procedures which the issuer and distributors must follow to assure compliance with the transaction restrictions during the appropriate restricted period. The transaction restrictions vary depending on the category of issuer and the class of se-

119. *See supra* note 117.

120. *See supra* note 18.

121. This may be true because the Section 4(1) exemption is for transactions not involving an issuer, underwriter, or *dealer* and the Section 4(3) dealer exemption does not become effective until 40 days after the first date the security was bona fide offered by or through an underwriter. Although the Section 4(3) 40 day exclusion from the dealer exemption generally has not been applied to securities issued pursuant to an exemption, it is not clear that Regulation S is an exemption for this purpose. *See infra* note 159. The fact that Rule 144A imposes special resale restrictions on securities issued by non-reporting foreign issuers suggests that the Commission may not regard the Section 4(3) exemption as available for resales in the United States. *See* §8[d]-[e].

122. *See supra* note 83.

123. *See* §6[f] *infra*.

curities. The offering restrictions consist of the following:

(1) The written agreement of every distributor (underwriters and dealers)[124] participating in the distribution "pursuant to a contractual arrangement" to offer and sell the security in compliance with the applicable transaction restrictions and other requirements of the safe harbor, or pursuant to registration or an available exemption.[125]

(2) The offering materials and documents must include statements to the effect that the securities have not been registered under the Securities Act, cannot be offered or sold in the United States or to U.S. persons within the applicable restricted period unless the securities are registered or an exemption from registration is available.

(3) Such statements must be included (a) on the cover or inside cover page of any prospectus or offering circular, (b) in the underwriting section of any prospectus or offering circular, and (c) in any press release or advertisement made by the issuer or any distributor or any person acting on their behalf.[126] The appropriate statements may appear in summary form on the prospectus cover pages (presumably with a cross-reference to the underwriting section) and in press releases and advertisements.[127] If the offering restrictions are applicable, and they are not complied with, the safe harbor is not available for the entire offering.[128] This is likewise the situation if the restrictions on directed selling efforts in the United States are not complied with,[129] whereas failure to comply with other conditions of a safe harbor would result only in the safe harbor not being available for the particular offer and sale to which the failure related.[130] The restricted period during which the Offering Restrictions must be complied with is a period which commences with the closing of the offering or the date when first offered to persons other than distributors in reliance on Regulation S, whichever is the later, and expires a specified period of time thereafter as provided in the appropriate transaction restriction.[131] In the case of a continuous offering, it does not commence until the lead managing underwriter certifies that the distribution has been completed.[132] In any event, a distributor holding an unsold allotment will be deemed in the restricted period at the time of sale.[133]

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124. The term "distributor" encompasses underwriters and dealers who participate in the distribution "pursuant to a contractual arrangement." Rule 902(c). This definition is broad enough to cover the underwriting and selling groups. The term, however, does not necessarily encompass all Section 2(11) statutory underwriters. *See* Proposing Release, *supra* note 2, at 89,133.

125. Rule 902(f)(1).

126. Rule 902(f).

127. *Id.*

128. *See* Reproposing Release, *supra* note 2, at 80,218.

129. *See supra* note 107.

130. Reproposing Release, *supra* note, at 80,218-19.

131. Rule 902(k).

132. *Id.*

133. Rule 902(k).

[e] Category 2 — Reporting Issuers and Foreign Debt Issuers

The category 2 safe harbor covers offshore debt or equity distributions by reporting issuers (U.S. and foreign) and debt issues with SUSMI of non-reporting foreign issuers.[134] Such distributions have the benefit of the safe harbor if (1) the general conditions of Rule 904[135] are complied with, (2) the offering is not made in the United States or to a U.S. person for a period of forty days commencing from the date of closing or by a distributor with an unsold allotment, (3) appropriate offering restrictions as described above[136] are adopted, and (4) during the forty day restricted period distributors selling securities to other distributors, dealers, and persons receiving selling concessions or other remuneration deliver a confirmation or other notice advising the purchaser that it is subject to the same restrictions applicable to the selling distributor.[137] No distinction is made as to the conditions of the safe harbor between debt and equity securities in this category or between debt of reporting and non-reporting foreign issuers. Although the offering restrictions require participants in the distribution not to offer or sell the securities in the United States or to non-U.S. persons during the applicable period, there is no specified procedure for determining whether purchasers are non-U.S. persons, no legend need be included on the certificates, and no agreement or certification is required from the purchasers, although, as discussed below,[138] purchasers need and have their own safe harbor for resales. A specific noncomplying sale affects only that one transaction. If adequate offering restrictions are adopted, and a distributor makes offers or sales in violation of the transactional restrictions, offers or sales by other distributors are not affected.[139] The Reproposing Release cautions, however, that if the underwriter knows, or is reckless in not knowing, that a dealer to whom it intended to sell part of the issue "had consistently sold to U.S. residents in violation of the resale restrictions," the underwriter could not rely on the safe harbor.[140]

A reporting company is an issuer with a class of securities registered under the Exchange Act or which is required to file reports pursuant to Section 15(d) of the Exchange Act and has filed all required reports during a period of twelve months immediately preceding the offer or sale, or such shorter period during which it was required to file such reports.[141] There is no requirement that a company have been a reporting company for any specified period of time; hence, even a start-up issuer could voluntarily register a class of equity securities under Section 12(g) of the Ex-

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134. Rule 905(b).
135. *See* §6[b].
136. *See* §6[d].
137. Rule 905(b).
138. *See* §7[a].
139. Reproposing Release, *supra* note 2, 80,218-19.
140. Reproposing Release, *supra* note 2, at 80,219.
141. Rule 902(j).

change Act and become a reporting company within the category 2 safe harbor.

Regulation S does not specifically provide that a subsidiary of a U.S. reporting company offering debt securities guaranteed by the parent will be deemed a reporting issuer for purposes of the safe harbor classification. If it is not, it is subject to the more severe restrictions of category 3. Form S-3, a simplified registration procedure under the Securities Act, provides that, if the parent guarantees debt securities of its subsidiary, Form S-3 can be used for the offering if either the parent or the subsidiary meet the eligibility criteria.[142] Since the investors will be looking primarily to the parent's credit reputation, there appears to be little justification not to look to it in determining whether the securities are issued by a reporting company. If Regulation S places the debt securities of the subsidiary into category 3 because it is not a reporting company, which appears to be the case, parent companies may be prone to make the offering directly to avoid the category 3 transaction restrictions.

Regulation S does not define debt securities and, therefore, it is not clear whether a debt security convertible into an equity security is a debt security, an equity security,[143] or both a debt and equity security.

[f] Category 3 Safe Harbor — For Non-Reporting U.S. Issuers and Equity Securities of Non-Reporting Foreign Issuers with a SUSMI

The category 3 safe harbor relates to the distribution outside the United States of all securities not covered by the other categories. This includes the offshore distribution of securities by a U.S. issuer which is not a reporting company and equity securities of a foreign issuer which is not a reporting company and which has a substantial U.S. market interest. In the case of such foreign issuers, the offering would be in category 3 rather than category 1 only if the distribution is multi-jurisdictional and, hence, not an ODO. The restrictions and other conditions of the category 3 safe harbor differ depending on whether debt or equity securities are offered. In the case of debt securities, the requirements are identical to those of securities of reporting companies in terms of the forty day restricted period, the application of the offering restrictions, and the confirmation that must be used in transactions between distributors and dealers. In addition, however, the securities on issuance must be represented by a temporary global certificate. The global certificate is exchangeable for definitive certificates at the expiration of the forty day restricted period. The purchaser to receive a certificate must certify that the securities are not owned beneficially by a U.S. person. In the case of equity securi-

142. Form S-3, General Instruction C.

143. Rule 405 under the Securities Act and Section 3(a)(11) of the Exchange Act and Rule 3a11-1 adopted thereunder all provide that securities convertible into equity securities are equity securities, but these definitions are not incorporated into Regulation S. *See* further discussion at §9.

ties, the restricted period during which the securities cannot be sold in the United States or to U.S. persons is twelve months rather than forty days. The offering restrictions and the confirmation requirements are applicable. In addition, to comply with the transfer restrictions, (i) the issuer must refuse to transfer securities if the sale was not made in compliance with the provisions of Regulation S, (ii) the investor purchaser of the securities must certify that he (she or it) is not a U.S. person (or is a qualified institutional buyer as defined in Rule 144A) and is not acquiring for the benefit of a U.S. person and (iii) the investor purchaser must agree to resell the securities only in accordance with the provisions of Regulation S, pursuant to registration or an exemption therefrom.[144] The means to implement the transfer restrictions on transfers to U.S. persons is up to the issuer. As a minimum, a transfer by a person with a non-U.S. address puts the issuer on notice and requires inquiry.[145] There is no specific requirement, however, that a legend be placed on the certificates.

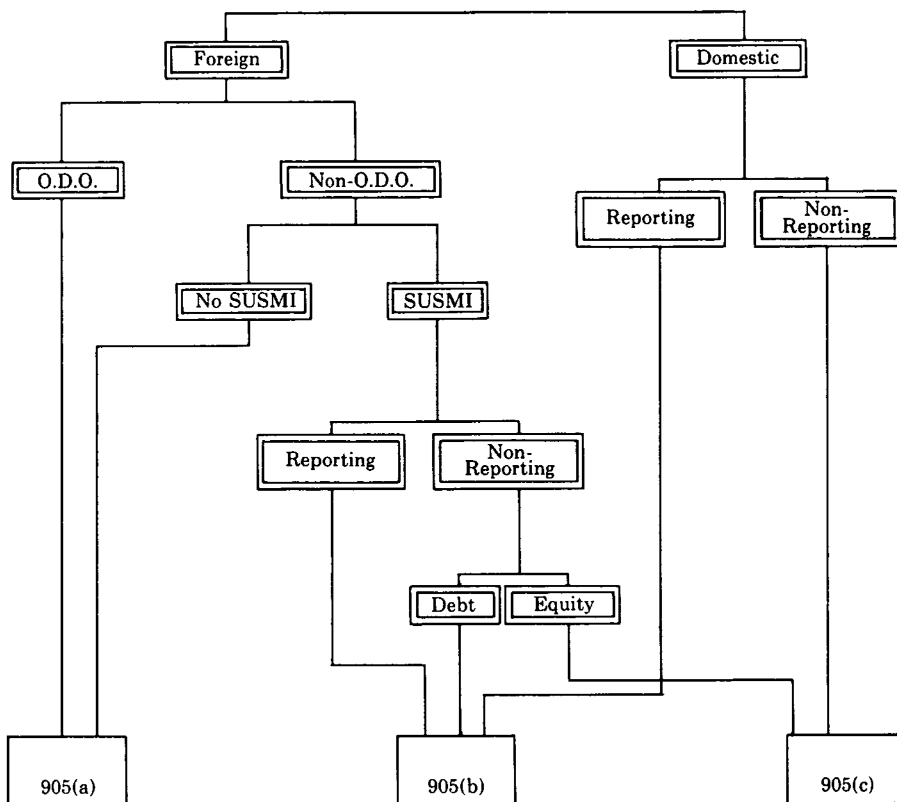
[g] The Appendix A Safe Harbor Summary

Appendix A to the Reproposing Release, which is reproduced below, is a helpful, tree-type guide and summary of how the sundry safe harbors apply to different types of offshore distributions by foreign and U.S. issuers respectively. One can readily discern from Appendix A that any ODO by a foreign issuer and any offshore offering of debt or equity security as to which there is no SUSMI by a foreign issuer are within the category 1 (Rule 905(a)) safe harbor. All other offerings by a foreign issuer are in category 2 (Rule 905(b)) except that an offering of a class of equity securities in which there is a SUSMI by a non-reporting issuer is within category 3 (Rule 905(c)). In the case of offshore distributions by U.S. issuers, all offerings by a reporting company are in category 2 and all offerings by a non-reporting company are in category 3.

144. Rule 905(c)(3).
145. Proposing Release, *supra* note 2, at 89,139.

APPENDIX A

RULE 905 CATEGORIES



O.D.O. = Overseas Domestic Offering

SUSMI = Substantial US Market Interest

§7 REGULATION S AND RESALES

[a] Securities Distributed Pursuant to Regulation S

There is a separate resale safe harbor for persons other than issuers and distributors.[146] Rule 906, however, deals only with sales outside the United States and does not provide a safe harbor for resales in the United States.[147] It is limited to resales by persons other than the issuer or distributor.[148] The investor-purchaser who is not a dealer or person receiving selling compensation or other selling remuneration can resell the securities without any restrictions other than the general conditions which require that the offer and sale take place offshore.[149] The further general condition that there be no directed selling effort in the United States is applicable only to the person selling the security. If the seller, however, is a dealer or other person receiving selling compensation, during the restricted period (which assumes a category 2 or 3 situation) such seller can resell subject to the same general conditions as the investor and purchaser, but neither the seller nor any person acting on his behalf can be aware of the fact that the offeree or buyer of the securities is a U.S. person. In addition, if the purchaser from such seller is also a dealer or person receiving a selling concession, the seller must deliver to the purchaser a confirmation or other notice stating that during the restricted period the securities can be sold only in compliance with Regulation S or pursuant to registration or an exemption from registration under the Act. The restricted period does not begin anew upon resale of the securities, but applies only to the remainder of the applicable period imposed in connection with the original distribution.[150]

The reproposed regulation does not specifically refer to resales on a foreign stock exchange or designated organized securities market since Rule 906 requires an offshore transaction which is specifically defined to include transactions executed in such markets. The accompanying release states that the resale safe harbor "would also permit resales of any securities on established foreign securities exchanges and designated organized

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146. Rule 906.

147. Preliminary Note 6 to Regulation S.

148. The Proposing Release contains some inconsistent statements in this respect. The Release states that once a distributor has distributed its allotment, it is like any other person reselling the securities it may reacquire. Proposing Release, *supra* note 2, at 89,133-34. Elsewhere the Release states that sales and "resales by issuers, distributors and their affiliates would *always* be subject to Rules 904 and 905" rather than 906. *Id.* at 89,139 (Emphasis added). A reasonable construction of all of this is that reference to resales is to those that are part of the distribution since there appears to be no reason to cut distributors out of the trading market once the distribution is completed so long as Rule 906 is complied with. This is reinforced by the specific restrictions applicable under Rule 906 to resales in that market by securities professionals included in reproposed Regulation S.

149. *See* §7[a].

150. Proposing Release, *supra* note 2, at 89,137.

foreign securities markets."[151] If the seller were a dealer, the notice delivery otherwise required would be required only if the seller knew that the purchaser was a dealer or person receiving selling remuneration.[152] Rule 906 as initially proposed restricted resales on exchanges to securities in the first two categories and specifically provided that neither the seller nor any person acting on his behalf can be aware of the fact that any counter-party to the transaction is a U.S. person.[153] This provision has been dropped from the Regulation, but awareness of the status of the counter-party is significant since Rule 902(g)(2) provides that the transaction in such market is not offshore if the seller or its agent is aware that the transaction has been pre-arranged with a buyer in the United States. The Proposing Release had said under its initial formulation that it was not intended to impose a duty of inquiry; the purpose was to avoid transactions pre-arranged in the U.S. and executed on a foreign exchange.[154] This comment appears appropriate with respect to the definition of an overseas transaction. The alternative of selling on a foreign exchange or designated organized foreign securities market ("DOFSM") is particularly significant as in most offerings made in the United Kingdom or Europe the securities are likely to be traded on an exchange or in an organized market established by an exchange once the distribution is completed. If, for example, a U.S. issuer which is a non-reporting company makes an offering in the U.K., concurrently listing the security on the Unlisted Securities Market (USM), the foreign investors who purchase securities in the offering can resell them through a U.K. broker who would sell them to a market-maker on the London (International) Stock Exchange on which USM securities are traded. The liquidity for such a security is as good as the market on which it is traded.

[b] Securities Issued in Reliance on an Exemption

Rule 906 is broadly framed so that it is not limited to the resale of securities issued in offshore transactions. It is also applicable to the resale of securities issued in the U.S. to U.S. persons in reliance on Regulation D or other exemption from registration and which are resold outside of the U.S. in reliance on Regulation S. The restricted period would commence on the date upon which the investor's securities were first resold in reliance on Regulation S.[155] If, for example, a U.S. resident purchased securities offered pursuant to Regulation D, prior to the expiration of the Rule 144 two-year holding period, he could sell them offshore complying with the provisions of Rule 906 and the restricted period imposed on his purchaser would commence with the sale to him, assuming it was the first offshore sale. If the securities are listed on a foreign securities exchange,

151. Reproposing Release, *supra* note 2, at 80,217.
152. *Id.*
153. Rule 906(b) as initially proposed.
154. Proposing Release, *supra* note 2, at 89,140.
155. *Id.*

they could be resold on the exchange in compliance with Rule 906 without regard to any restricted period.[156]

This aspect of Regulation S may prove to have considerable practical significance, particularly as to securities privately placed in the United States. If the security is traded on a foreign exchange or a DOFSM, purchasers would not have to hold the securities for the two-year holding period of Rule 144 in order to resell the security and insofar as the U.S. securities laws are concerned would have the liquidity afforded by the foreign securities market.

[c] Resales in the United States or to U.S. Persons

During the twenty-five years since the pronouncement of Rule 4708, the SEC staff has given repeated no-action letters as to what it would deem as adequate restrictions or lock-ups during the distribution and during a period following the completion of the distribution. The Proposing Release states as follows: "The staff traditionally has not expressed any view as to when or under what circumstances securities issued pursuant to Release 4708 could be resold in the United States or to U.S. persons. Rather, the staff has indicated that resales may be made only in compliance with the registration requirements of the Securities Act or an exemption therefrom."[157] The resales in the United States under 4708 had to find a Section 4(1) or other exemption;[158] Regulation S as proposed, unfortunately, does not wholly dissipate this issue. The reproposed regulation is somewhat less confusing in this respect than the regulation as initially proposed and there is a strong implication that the securities can be resold in the United States or to U.S. persons after the end of the restricted period. The issue, nonetheless, is not free from doubt.[159]

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156. *Id.* Presumably, Rule 906 could also be used to resell securities offered in the United States in reliance on Rule 147.

157. Proposing Release, *supra* note 2, at 89,125.

158. *See* §3 *supra*.

159. To fully understand the issues in this regard from a conceptual standpoint it is necessary to digress; a digression justified, perhaps, by the fact that it is also relevant to Rule 144A and the somewhat timid approach taken by the Commission. *See* §8[c]. James Landis and Benjamin Cohen, young proteges of Felix Frankfurter, then a Harvard Law School Professor, drafted what became the Securities Act of 1933, with very little in the way of a model to follow, as they rejected a blue-sky approach. *See* J. SELIGMAN, THE TRANSFORMATION OF WALL STREET (1982), at 63-68. In a stroke of genius, Landis and Cohen hit on an approach that in a few short paragraphs regulated a multitude of transactional situations, some of which they had no way of foreseeing (e.g., the development 40 years later of the Eurobond market). Section 5 of the Securities Act provides it is unlawful, absent an exemption, to sell securities that are not registered. Section 2(11) defines an underwriter as one acquiring shares from an issuer or an affiliate of an issuer with a view to distribution. In this rather simple fashion they achieved two goals: (1) to require registration whenever an issuer distributes securities, and (2) to require registration whenever affiliates (i.e., controlling persons) distribute securities. In addition, it was necessary to separate out trading transactions so that every time someone trades a security it would not be necessary to file a registration statement. This they did by providing an exemption for transactions not involving an issuer,

Regulation S takes the form of a Rule defining offer, offer to sell, offer for

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underwriter, or dealer. A further exemption, now Section 4(3), exempts dealer transactions other than for a period of time following the effective date of a registration statement during which dealers must deliver a statutory prospectus in connection with offerings by a non-reporting company and certain transactions in unregistered securities. Accordingly, for most purposes, one can read Section 4(1) as if it were an exemption for transactions not involving an issuer or underwriter.

Section 4(1) in conjunction with the Section 2(11) definition of an underwriter provides yeoman services. Never have so few words served so many purposes. As noted, in the public offering context it requires a public offering by an issuer or an affiliate to be registered. It also permits purchasers in a registered offering to resell securities without registration and for non-affiliates to trade the securities in the secondary market. Most importantly, for our immediate purposes, it also determines the extent to which securities acquired from an issuer in exempt transactions can be resold without registration. Exempt transactions run the gamut from the Section 4(2) exemption for transactions not involving a public offering, to the three Regulation D exemptions (Rules 504, 505, and 506), the intrastate offering exemption, the Section 3(a)(9) exemption for an exchange offer of one class of securities of an issuer for another class of the same issuer. Rule 144, which requires a minimum holding period of two years, provides a path for leakage into the public markets of securities issued in reliance on the Section 4(2) or Regulation D exemptions. Rule 147(e) provides a similar route for securities issued in reliance on the Section 3(a)(11) exemption if not resold into the interstate securities markets until nine months after the completion of the distribution.

Since Regulation S fails to specifically provide that resales in the United States after the expiration of the restricted period are within the Section 4(1) exemption, the availability of an exemption for such resales will depend upon the application of the Section 4(1) and 4(3) exemptions. Conceptually Regulation S provides that offshore offers and sales made in conformity with Regulation S are not deemed offers or sales for purposes of Section 5. Rules 901 and 903. Arguably, if there has not been an offer or sale for purposes of Section 5, the investor-purchaser is not an underwriter as it has not "purchased" a security with a view to distribution. This would leave the question of whether there would be a Section 4(3) exemption for dealers that made a market in the security distributed offshore pursuant to Regulation S after expiration of the restricted period. Section 4(3)(A) provides that the dealer exemption is not available with respect to unregistered securities until 40 days after the securities are first bona fide offered to the public by the issuer or by or through an underwriter. It has been held that this period does not commence to run until the securities are first publicly offered in the United States and this occurs when they are first quoted in an inter-dealer quotation system (as distinguished from when first traded). Kubik v. Goldfield, 479 F.2d 472 (3d Cir. 1973); SEC v. North American Research & Development Corp., 280 F. Supp. 106, *aff'd in part*, 424 F.2d 63, 81 n.14 (2d Cir. 1970); Lustgart v. Albert Teller & Co., 304 F. Supp. 771, 772 (E.D. Pa. 1969). In all of these cases, however, the securities were sold in the United States in violation of Section 5 as the seller was a statutory underwriter and, hence, did not have a Section 4(1) exemption. In fact, historically, Section 4(3)(A) has been applied only to securities distributed in violation of the registration provisions, although literally it is not so restricted. Section 4(3) clearly has no application to securities exempt pursuant to Section 4(2) or Rule 506 as Section 4(3)(A) is applicable only to securities publicly offered. In the context of an issuer exchange offering exempt under Section 3(a)(9), notwithstanding the fact that it involves a public offering, the Commission early on took the position that dealers are not subject to the requirement of delivering a prospectus under the dealer exclusion of the then third clause of Section 4(1) with respect to securities offered pursuant to an exemption. Securities Act Release No. 646 (Feb. 3, 1936). *See also* Jerome L. Coben, SEC No-Action Letter (March 12, 1986). When Section 4(1) was amended so as to move the dealer exemption into Section 4(3) and reduce the period of time during which dealers had to deliver a prospectus in the secondary market after completion of a public offering, the language of 4(3)(A) was added. It is clear from the legislative history that this was intended to make the exemption unavailable for securities distributed in violation of

sale, sale and offer to buy so that offers and sales made outside of the United States are not offers or sales for purposes of Section 5 and those made in the United States are offers or sales for purposes of Section 5.

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the registration provisions and that same legislative history indicates that it was not intended to affect "the nature or extent of the dealer's exemption." S. REP. No. 1036, 83d Cong., 2d Sess. 14 (1954). The critical question then is whether Regulation S is to be viewed as an exempt offering for this purpose. The fact that Rule 144A expressly includes a dealer exemption (*See* §8[e] *infra.*) suggests that it may not although such inclusion may merely be to avoid any question in this context. If it is not, the 40 day period should be measured from the public offering outside of the United States as otherwise a dealer could not effect a trade until someone placed a quotation in an inter-dealer quotation system and initiated a 40 day period in which all trades would be in violation of Section 4(3).

The problem of applying Section 4(1) initially achieved prominence in the context of securities issued in reliance on the Section 4(2) exemption for private placements. Rule 144 has been a regulatory success story in terms of encouraging private placements in which purchasers can assure themselves of acquiring a privately placed security that ultimately will have liquidity, in providing a reliable guide to dealers and selling shareholders as to when and to what extent restricted securities can be sold without registration, and in providing a stock of additional securities for the trading market. Conceptually, the resale exemption is based on declaring that persons reselling securities are not Section 2(11) underwriters if they comply with the Rule (Rule 144(b)) and that the broker effecting the unsolicited transaction initially required by the Rule is exempt under Section 4(4). (Rule 144(f) & (g)).

The other way of reselling securities issued in exempt transactions is to sell them in a private transaction. Conceptually the Section 4(2) exemption is not available for such transactions as Section 4(2) is an exemption for transactions with an issuer not involving a public offering. Further, whether Section 4(1) is available depends upon whether the purchaser is a statutory underwriter which in turn depends upon whether he purchased with a view to distribution as distinguished for investment. If a view to distribution were synonymous with a view to resale, then resales to private purchasers might result in characterization of the reseller as an underwriter. Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959) resolved all of this by interpreting the "with a view to distribution" language of Section 2(11) as meaning with a view to selling in a public offering and by applying the SEC v. Ralston Purina Co., 346 U.S. 119 (1953), criteria for determining the availability of the Section 4(2) exemption to the resales in determining whether or not the seller is a statutory underwriter. The result is a Section 4(1-½) exemption for resales of securities acquired in a exempt transactions to sophisticated investors who have access to substantially the same information that would be available in a registration statement.

Although the 4(1-½) exemption developed in the context of a Section 4(2) private placement, it would appear applicable to any security issued in an exempt transaction if emphasis is placed on the fact that it is in fact a Section 4(1) exemption and the ultimate issue is whether the purchaser in the exempt transaction is a statutory underwriter. It could be argued that if the repurchaser is merely sophisticated and not an accredited investor that there are more than 35 purchasers in a Rule 506 and 505 offer if there are resales in reliance on *Gilligan, Will*. The restriction on resales, however, imposed by Rule 502(d) for this purpose attributes to securities acquired under Reg. D the status "of securities acquired in a transaction under section 4(2)" and the issuer must "exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(11) of the Act." Rule 144A is a codification, and a narrow one at that, of the 4(1-½) exemption, providing a conclusive presumption that if the conditions of the Rule are complied with that the purchaser will be deemed able to fend for itself. Conceptually it also takes the form of providing that the non-issuer seller of securities complying with the conditions of the Rule will not be deemed an underwriter for purposes of Section 2(11) or for purposes of Section 4(1) of the Act. Rule 144A(b). See the further discussion of Rule 144A at §8.

Regulation S includes a number of safe harbors which, if complied with, result in the offer or sale being deemed made outside of the United States and, hence, not subject to Section 5. Regulation S, however, does not deal with resales into the United States except, possibly, by implication. If such resales are to find an exemption, presumably they will have to find it for the seller under Section 4(1) of the Securities Act for transactions not involving an issuer, underwriter, or dealer and for the dealer under the Section 4(3) dealer exemption.[160] Rule 144A is explicitly available for such resales.[161] Although securities sold offshore are not technically restricted securities for purposes of Rule 144, the staff has treated them as such and the proposed amendments to Rule 144 make explicit provisions for securities that ordinarily would have been distributed in reliance on Regulation S.[162]

There are two relevant resale periods: while the Regulation S transaction restrictions are still in effect and after such restricted period. There are two relevant prospective purchasers in a resale; offshore purchasers who are not U.S. persons and U.S. purchasers (sales made in the U.S. or offshore to U.S. persons). Regulation S deals directly only with offshore purchasers; it does not distinguish explicitly between the two relevant resale periods, and the offering restrictions, which are intended to give notice of the specific conditions to which the offshore purchasers are subject, do not deal with the status of the securities after termination of the restricted period except by implication.

The category 1 safe harbor has no specific restricted period as there are no offering restrictions or transaction restrictions, merely general conditions one of which is that the securities be sold and resold offshore. Presumably, this condition does not continue for category 1 securities any longer than it would for category 2 securities. One cannot be certain, however, since Rule 144A as proposed and the proposed amendments to Rule 144 appear to be designed to keep securities of non-reporting foreign issuers either offshore or within a market confined to qualified institutional investors.[163] The category 2 safe harbor precludes any sales of securities of a reporting issuer in the U.S. or to U.S. persons for forty days after the closing;[164] and the category 3 safe harbor imposes a forty day restricted period on debt securities in that category and a twelve month restricted period on equity securities.[165] Sales can be made in the United States or to U.S. persons if the securities are registered or an exemption from registration is available during the restricted period. There is nothing in the restrictions relating to sales in the United States or to U.S. persons of securities of reporting companies and debt securities of non-reporting

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160. *See supra* note 159.
161. *See* §8.
162. *See* §8[e].
163. *Id. See also supra* note 121.
164. Rule 905(b)(2).
165. Rule 905(c)(2)-(3).

companies that extends beyond forty days after the closing nor as to category 3 equity securities beyond one year. The purchaser, however, as to category 3 equity securities must agree to resell such securities only in accordance with Regulation S, or if the securities are registered or exempt from registration. These conditions literally continue indefinitely.[166] The offering restrictions, however, which are designed to put the purchaser on notice of the transaction restrictions specifically refer to limitations on offers and resales by the purchaser "within the restricted period."[167] Similarly, the notice disclosure required of dealers under Rule 906 (which is applicable to both categories 2 and 3 securities) also refers to limitations on resales "during the restricted period."[168] The reasonable construction, therefore, appears to be that all the transfer restrictions in the Regulation are applicable to the restricted period only.

Regulation S, however, purports to deal only with offshore distributions and does not specifically provide when shares may be resold to U.S. persons or in the United States. The implication that one would ordinarily make is that once the restricted period has expired the securities can be freely resold in the United States. There is, however, the troubling fact that under Release 4708 the staff always insisted that at the end of the lock-up period an appropriate exemption had to be found for the sale of the securities in the United States or to U.S. persons.[169] Somewhat ominously, the reproposed Regulation includes a Preliminary Note 6 which, although not specifically referring to the period after the restricted period, says something very similar: "Securities acquired overseas, whether or not pursuant to Regulation S, may be resold in the United States only if they are registered under the Act or an exemption from registration is available."

The Proposing Release contains a number of statements that deal with this issue although it is difficult to reconcile them with Preliminary Note 6. Commenting on the General Statement, the Proposing Release observes that "if the distribution has been completed and resales into the United States are only made in routine trading transactions," generally the securities "would be considered to have come to rest abroad."[170] Spe-

166. Rule 90b(c)(3).

167. Rule 902(f)(2).

168. Rule 906(b)(2).

169. *See supra* note 157. The following is a fairly typical statement of the old staff position. "[W]e express no view as to when or under what circumstances the securities may be reoffered or resold in the U.S. or to its citizens or residents. Any such reoffers and resales must be made in compliance with the registration requirements of the 1933 Act or pursuant to an exemption thereunder. The availability of any such exemption would depend upon the facts and circumstances existing at the time of such reoffers and resales." Sears Overseas Finance N.V., SEC No-Action Letter (June 11, 1982).

170. Proposing Release *supra* note 2, at 89,132. The comment was prefaced with the reiteration of a statement in Release 4708 to the effect that trading in the United States shortly after completion of the distribution would be an indication that the distribution was "in fact being made by means of such trading." *Id.* The Release then discusses flowback, noting that equity is more likely to flowback to the issuer's home country or primary market

cifically, the Release states, referring to securities of a reporting issuer, that the purpose of the transactional restrictions is not to prevent flowback, but "to prevent securities from entering the U.S. capital markets while the market has been preconditioned for such securities . . . ."[171] The Proposing Release further sets forth as one of the basic propositions of the safe harbor provisions "that periodic reporting under the Exchange Act can be relied upon for the protection of investors once the marketing effort has been completed. After the foreign distribution has been completed and the marketing efforts have terminated, routine secondary trading may begin as a matter of course. Where issuers are not subject to the reporting requirements of the Exchange Act, resale restrictions previously developed under Release 4708 to protect against flowback would continue."[172] This suggests that once the restricted period has expired, the securities of a reporting issuer can be traded in the United States; presumably, in reliance on the Section 4(1) exemption for transactions not involving an issuer or underwriter and the Section 4(3) dealer's exemption, but that securities of a non-reporting issuer may have to be registered or an exemption established. The Proposing Release also specifically states in the section dealing with securities of a reporting company as follows: "Upon expiration of the restricted period, securities sold in reliance on the safe harbor will be viewed as unrestricted."[173]

The Proposing Release expressed concern about the flowback of equity securities of non-reporting companies because of the lack of information about them in the marketplace.[174] This may or may not explain the staff's apparent reluctance to acknowledge as to such securities that after the appropriate restricted period the securities can be resold in the United States without registration in reliance on Section 4(1) much as securities which are registered or offered pursuant to Regulation A can be resold by the ordinary investor.[175] The Proposing Release suggests that Regulation S imposes substantially the same restrictions as *InfraRed* on securities of a non-reporting issuer.[176] Those restrictions required that after the restricted period the securities could be resold in the United States only pursuant to registration or if an exemption was available, or they could be resold offshore on a foreign securities exchange. This obvi-

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than debt and that the existence of a trading market in the security in the United States increases the likelihood of flowback. *Id.* at 89,133. This seems to assume that so long as there is any danger of flowback to the United States that the securities have not come to rest offshore. Perhaps, it means no more than that a longer period of time must elapse between the completion of the distribution and routine trading transactions in the United States in the case of equity securities that have a trading market in the United States in order for the securities to be deemed to have come to rest offshore.

171. Proposing Release, *supra* note 2, at 89,136.

172. *Id.* at 89,129.

173. Proposing Release, *supra* note 2, at 89,137 n.113. The same note observes that this would not be true as to securities held by a distributor representing an unsold allotment.

174. Proposing Release, *supra* note 2, at 89,138.

175. *See* SFCL, *supra* note 58, §4.08[2][e].

176. Proposing Release, *supra* note 2, at 89,139. On the *InfraRed* restrictions, see §3.

ously is something less than being unrestricted after the expiration of the restricted period (twelve months as to category 3 equity securities).

Regulation S, although cast in terms of offers and sales that occur outside the United States, nonetheless, focuses on the concept of securities coming to rest outside the United States as being determinative of whether a distribution is in fact completed outside the United States. The other side of that coin is whether or not purchasers are statutory underwriters as that term is defined by Section 2(11) of the Securities Act. If the securities have come to rest, the distribution in the Section 2(11) sense is completed and, absent extraordinary circumstances,[177] persons other than affiliates of the issuer can resell the securities in reliance on the Section 4(1) exemption for transactions not involving an issuer or an underwriter.[178] On this basis, once the restricted period of the specific safe harbor provision has expired, the securities should be deemed to have come to rest and the distribution ended so that thereafter the securities can be resold in the U.S. or to U.S. persons in reliance on the Section 4(1) exemption.[179] Unfortunately, neither proposed Regulation S nor the Proposing or Reproposing Release explicitly so states.

The question is somewhat less disconcerting if the securities are listed on a foreign exchange or traded in a designated organized foreign securities market. In that event, the securities could be resold on the exchange or the DOFSM during the restricted period as well as after under the provisions of Rule 906.[180] The issuer, however, in the case of category 3 equity securities, would have an obligation not to transfer the securities unless such transfer is made in compliance with Regulation S.[181] Query whether this precludes a transfer to a U.S. purchaser of securities resold pursuant to Rule 906 on a foreign stock exchange.[182] A distributor is precluded from selling category 3 equity securities to a U.S. person for a period of one year, but there is no express limitation on the resale by the foreign investor-purchaser under Rule 906(a) other than the general conditions. To be an offshore transaction under Rule 902(b)(g) neither the seller nor any person acting on the seller's behalf can know that the

177. The now largely discredited presumptive underwriter doctrine might treat someone purchasing a large part of the offering as a statutory underwriter even after the securities have come to rest. *See* SFCL, *supra* note 58, §5.06 n.7.

178. *See supra* note 159.

179. Compare the coming to rest concept of the Rule 147(e) safe harbor under which an intrastate offering is deemed to come to rest within nine months after the completion of the distribution. A court has held that under the particular circumstances of the case securities sold in reliance on the intrastate offering exemption and resold in the interstate market after seven months had come to rest notwithstanding Rule 147(e). Busch v. Carpenter, 827 F.2d 653 (10th Cir. 1987).

180. *See* §7[a] *supra*.

181. *See* §6[f] *supra*.

182. If the buyer during the restricted period turns out to be a U.S. person, the buyer will have no notice of the restrictions and will be quite surprised if on transfer the issuer refuses to transfer the securities in compliance with the category 3 restrictions relating to equity securities.

transaction has been pre-arranged with a buyer in the United States. This probably does not impose any duty on the seller to inquire as to the residence of the buyer provided the transaction is not pre-arranged with a U.S. buyer.[183] The transaction restrictions, however, expressly require the issuer to refuse to transfer the securities to a U.S. person during the restricted period. The effect will be to require the U.S. purchaser to resell the securities during the restricted period in the foreign market and keep the securities from being traded in the United States during the restricted period unless registered.

There is also the opportunity for securities sold offshore to make their way back to the United States through the private market that is expected to develop as a result of the adoption of Rule 144A. One of the purposes of Rule 144A is to permit qualified U.S. institutional investors to acquire securities, particularly securities of foreign issuers, distributed offshore. If a Rule 144A purchaser acquires securities of a reporting issuer during the forty day restricted period, an interesting question arises as to whether the securities would no longer be restricted after the expiration of the forty day period. On the assumptions made above, such securities would be unrestricted if held by the foreign investor for the entire period. Securities sold in reliance on Rule 144A, however, are restricted securities as defined by Rule 144(a)(3).[184] If this is the appropriate classification, Rule 144 would require a two year holding period measured under proposed revisions to Rule 144(d)(1) from the date initially purchased from the issuer. Under these assumptions, qualified institutional investors presumably would purchase the securities only if convinced that there will be a liquid Rule 144A market for them and ordinarily will prefer purchasing them on the foreign market in which they trade. In the case of category 1 securities issued by a foreign issuer, the qualified institutional investor (or, for that matter, any institutional investor) could purchase the security in the initial distribution in an offshore transaction, but that would require a presence offshore to effect the transaction.[185]

The proposed amendments to Rule 144 and the reproposed Rule 144A[186] treat securities of foreign issuers which are non-reporting companies differently from all other securities in an apparent attempt to prevent their leakage into the public U.S. markets. The approach is discussed below as part of the discussion of Rule 144A.[187] The implication is that such securities do no lose their restricted character after the expiration of the restricted period (as to category 3 securities) and that category 1 securities of a non-reporting foreign issuer are restricted notwithstanding the absence of a restricted period.

The extent to which trading will be precluded beyond the restricted

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183. *See supra* note 154.
184. Rule 144A.
185. *See* §6[c] *supra*.
186. *See* §8[e].
187. *See* §8 *infra*.

period depends on resolution of the issues discussed above. Such issues, unfortunately, give rise to the type of theology prevalent for years relating to "investment intent" prior to the adoption of Rule 144.[188] For the most part, it will not be a concern of the underwriters who can rely on the safe harbor except to the extent some of the participants in the underwriting may be concerned about their clients and insist on an opinion as to the free trading nature of the securities after the restricted period. Qualified institutional purchasers will also have concerns in this regard and may want assurance in the form of an opinion of counsel. It will also be of concern to issuers, particularly with respect to category 3 equity securities, as to which issuers must establish a mechanism for preventing transfers of record to U.S. purchasers. Although in most instances, a resale after the restricted period, if a violation of Section 5, should not place the entire "exemption" in jeopardy,[189] it, nonetheless, will be a troublesome transfer agency problem and will place a premium (as was the case of pre-Rule 144 opinions) on obtaining an opinion from counsel who tends to see the issue in oversimplified terms. The most concerned party, perhaps, should be the National Association of Securities Dealers. The NASD proposal to establish the PORTAL market assumes that the NASD and its members will be responsible for determining when securities can exit the private market[190] and uncertainties in this regard as to securities distributed under Regulation S could introduce severe inefficiencies.

In the case of reporting issuers, there may be little difficulty in relying on statements in the Proposing Release that after the end of the restricted period the securities can be traded in the United States. This was probably the general position of the bar under Release 4708, notwithstanding the staff's admonitions. There is little evidence that enforcement personnel of the Commission attempted to police leakage into the U.S. securities markets of securities distributed under 4708 once the lock-up period expired. It would, nonetheless, be helpful if Regulation S specifically stated that persons acquiring securities issued in compliance with the provisions of Regulation S will not be deemed an underwriter for purposes of Section 4(1) and that dealers have the Section 4(3) exemption with respect to sales in the U.S. or to U.S. persons after the expiration of the restricted period. If the Commission is intent on making distinctions in this regard (e.g., reporting issuers versus non-reporting issuers generally or non-reporting foreign issuers specifically) on the basis of public policy, this should be done by Rule and not through ad hoc staff interpretations of Section 4(1).

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188. *See* SFCL, *supra* note 58, §§4.08[2][d], 4.10.

189. *See supra* note 130.

190. *See* §8(g).

§8 PROPOSED RULE 144A AND INTERRELATIONSHIP OF REGULATION S WITH RULE 144 AND PROPOSED RULE 144A

[a] Introduction

Although not referred to in Regulation S, it was the position of the staff under Release 4708 that securities distributed in reliance on the Release would be treated as restricted securities for purposes of Rule 144 and could be resold in compliance with Rule 144 after the appropriate holding period.[191] This would require a two year holding period before such an exemption would be available[192] and would be relied upon only if there is not a Section 4(1) exemption at the end of the Regulation S restricted period. It provides a conservative (and last resort) means of assuring that securities sold offshore can be resold in the United States without violating Section 5. The Commission has proposed to amend Rule 144 so as to increase the liquidity in the "market" for restricted securities. However, it has done so in a fashion, as is discussed below, that reflects considerable concern about the flowback into the United States of securities of non-reporting foreign issuers offering securities offshore in reliance on Regulation S.

Rule 144A was proposed in October of 1988[193] and reproposed in a drastically revised form in July of 1989.[194] The reproposal was accompanied by requests for comments in a number of areas and the Rule as finally adopted may differ from the proposed rule. Rule 144A is not an exemption for issuers, but like Rule 144, is an exemption for persons reselling securities acquired in exempt transactions, including for this purpose, securities sold pursuant to Regulation S. If Rule 144A is adopted, securities distributed offshore could be resold at anytime by the purchasers to institutional investors meeting the prescribed qualifications of the rule whether the sale is in the U.S. or offshore. The availability of the exemption depends upon (1) the buyer, (2) the security, and (3) complying with the formalities imposed by the rule. It is a narrow and restricted codification of what has been referred to as the Section 4(1-½) exemption, involving the resale of securities acquired in an exempt transaction to purchasers able to fend for themselves.[195] As *Gilligan, Will* emphasized, the purchasers to meet the *Ralston Purina* criteria (1) must be

191. Int. Income Property, Inc., SEC Div. Corp. Fin. No-Action Letter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶76,785 (Dec. 12, 1980).

192. Rule 144(d)(1). In many instances, for securities not traded in the United States it would require a three year holding period since it would not be possible to effect the transaction in the manner required by Rule 144(f) and/or to satisfy the current information requirement of Rule 144(c). Reliance in that event would have to be placed on the three year holding period of Rule 144(k). Query, however, if Rule 144 would be available at all under those circumstances since the no-action position does not specifically deal with the availability of Rule 144(k) for securities distributed offshore.

193. *See* Rule 144A Proposing Release, *supra* note 2.

194. *See* the Rule 144A Reproposing Release, *supra* note 2.

195. *See supra* note 159 for a discussion of the Section 4(1-½) exemption.

sophisticated and (2) must have access to the same information as would be available if the securities were registered.[196] Under Rule 144A, certain institutional investors as to certain categories of securities are deemed to be sophisticated and are conclusively presumed to have access to the appropriate information. Being freed of the latter responsibility is no insignificant concession; *Gilligan, Will* found a Section 5 violation because the sophisticated investors had not been furnished with adequate information.[197] Rule 144A is not exclusive and it is apparent that many transactions that will not have the benefit of Rule 144A in its initial incarnation are exempt under a *Gilligan, Will* Section 4(1-½) analysis.[198]

[b] Qualified Institutional Buyers

To be a qualified institutional buyer, the buyer must be an institution described in Rule 144A(a) and at the end of its last fiscal year it must have assets invested in securities that were purchased for more than $100,000,000. Institutional buyers are defined substantially in the same manner as accredited institutional investors in Rule 215 and Rule 501(a)(1)-(7) of Regulation D except self-directed pension plans and accredited investors who are natural persons are not included.[199] Institutional buyers include banks, savings and loan associations, insurance companies, broker-dealers, registered investment companies, an employee benefit plan if investment decisions are made by certain specified plan fiduciaries, broker-dealers registered under the Exchange Act, any corporation or Massachusetts or similar business trust, and tax-exempt charitable corporations. The $100 million investment in securities criterion excludes a large number of institutional investors. According to statistics cited by the Commission there are approximately 3,000 of the institutional investors in the principal categories that will meet the criteria.[200] Qualified institutional buyers also include any investment company registered under the Investment Company Act which is part of a family of registered investment companies with aggregate total investments in securities at a cost exceeding $100 million, and any registered investment adviser with investments in securities at a cost in excess of $100 million (including for this purpose investments in securities which it purchased and which it manages for the accounts of others).[201]

There is an important qualification relating to most of the qualified institutional investors; that is, they are qualified institutional investors

196. Gilligan, Will & Co. v. SEC, 267 F.2d 461, 466 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959).

197. 267 F.2d at 466-67.

198. *See supra* note 159.

199. Rule 144A(a)(1).

200. Reproposing Release, *supra* note 2, at 80,224 n.16.

201. Rule 144A(a)(2). There are also special provisions for determining the $100,000,000 invested in securities criterion for banks and other institutions investing in a fiduciary capacity and for bank holding companies. *See* Rule 144A(a)(4)-(6).

only with respect to purchases for their own account. This will be particularly difficult for investment advisers since, although they may include managed portfolios in determining whether they meet the $100 million criterion, they are not Rule 144A purchasers with respect to purchases made for the accounts managed by them.[202] There is, however, a special category for banks and savings and loan associations and similar institutions which exercise investment discretion with aggregate assets invested in securities purchased at a total cost of more than $100 million. Such institutions are Rule 144A purchasers when "acting in a fiduciary capacity."[203] The high qualification requirements will also exclude most broker-dealers; according to statistics included in the Reproposing Release only 102 broker-dealers will qualify as Rule 144A purchasers.[204] This is unfortunate because the real promise for a liquid Rule 144A market lies in broker-dealers acting as market makers and only those meeting the definition of a qualified institutional investor will be able to do so. There may well be a number of revisions in the definition of qualified institutional investors in the rule when adopted.

[c] Eligible Securities

Although not used in the Rule and not a defined term, the concept of "fungible securities" plays an important role in determining securities that do not have the benefit of the Rule. The concept under the reproposed rule embraces securities which are part of the same class as securities listed on a U.S. securities exchange or traded in an automated U.S. inter-dealer quotation system (which includes NASDAQ, but excludes the pink-sheet market), and securities issued by a registered open-end investment company, unit trust, or face-certificate company.[205] Securities not traded in any organized securities market or only traded in the "pink sheets" or other non-automated inter-dealer trading system, and securities traded on a foreign securities exchange or DOFSM are not fungible securities for this purpose. Securities which were not fungible *when issued* and which are sold to a qualified institutional buyer have the benefit of the safe harbor provided for by Rule 144A provided the additional conditions of the Rule are complied with.[206] A convertible security, if it can be converted into the underlying security within three years from the date of issuance, is two securities both of which (the convertible security and the underlying security) must be non-fungible in order for the safe harbor to be available.[207] Fungible securities do not have the protection of Rule 144A and reliance would have to be placed on the Section 4(1-½) exemption even though the transaction is with a qualified institutional

202. Rule 144A(a)(2).
203. Rule 144A(a)(4).
204. Reproposing Release, *supra* note 2, at 80,224 n.16.
205. *See* Rule 144A(d)(3).
206. Rule 144A(d).
207. Rule 144A(d)(3)(i).

investor.

[d] Informational Requirements and Other Conditions

In all transactions in which the seller relies on Rule 144A, the seller must take reasonable steps to assure that the buyer is aware that the seller may rely on Rule 144A. If the issuer of the securities sold in a Rule 144A transaction is a reporting company and the foregoing conditions are complied with, there are no further conditions. If the issuer is a non-reporting company, with the exception noted below, upon request of the buyer the seller must furnish the buyer with a brief description of the issuer's business and the product or services it offers; its most recent balance sheet and income statement and similar statements for the preceding two fiscal years which should be audited to the extent available.[208] If the issuer is a foreign issuer, which is a non-reporting company but which is exempt from registration under the Exchange Act by Rule 12g3-2(b) (which requires it to file with the Commission such reports and other related information that it must file with the authorities and the stock exchange in the country in which it is domesticated), the seller does not have to furnish such information.[209]

The requirement that information relating to non-reporting companies be furnished by the seller upon request has drawn the criticism of the investment banking community.[210] There is concern as to how the sellers will obtain such information which will have to come either from the issuer, reports of the issuer if such are available, or from secondary sources. The need to furnish such information, if requested, will introduce inefficiencies to the market process. There is also concern about potential liability for the information the sellers furnish. The PORTAL market discussed below will not rectify this situation as the NASD has rejected the notion that such information be inputted on the PORTAL computer. Since qualified institutional investors have extensive research resources available to them, imposing such obligation on the seller appears unnecessary. By the same token, however, it appears unlikely that most eligible purchasers will request such information unless it is not conveniently available to them.

There are approximately 1500 foreign issuers which file the necessary home country reports with the SEC in order to maintain the Rule 12g3-2(b) exemption from the registration and reporting requirements of the Exchange Act.[211] Presumably, most of these securities trade in the United

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208. Rule 144A(d)(4).

209. *Id.*

210. *See* letter of the Securities Industry Association (SIA) dated September 12, 1989 commenting on the reproposed Rule 144A.

211. *See* Multi-Jurisdictional Disclosure Release, *supra* note 2, at 80,284. According to this release there were also 516 foreign issuers that filed periodic reports (that is were registered) with the Commission under the Exchange Act which includes 150 foreign securities traded on U.S. securities exchanges and 291 quoted in NASDAQ (99 in the National Market

States to some extent, generally in the National Daily Quotation Sheets (the "pink sheets"). Although treated as a reporting company for the limited purpose under Rule 144A of determining the information that has to be furnished upon request to purchasers, the securities of such companies are subject to restrictions on trading in the Rule 144A market not applicable to reporting companies or non-reporting U.S. issuers. If securities of a non-reporting foreign issuer are traded on a foreign exchange or in a designated organized foreign securities market and have been quoted in a U.S. inter-dealer quotation system (which would include the "pink sheets") during the previous twelve months, certain additional conditions designed to prevent flowback to the United States must be complied with in connection with a Rule 144A sale involving securities of the same class. Specifically, the seller or any person acting on its behalf must take reasonable steps to assure that the securities are resold in the United States only if the securities are registered or exempt from registration. Such steps are conclusively deemed to be reasonable if they include an undertaking from the buyer to resell them only if the securities are exempt or registered and a procedure is established that is reasonably designed to prevent the securities from being transferred to other than qualified institutional buyers unless registered or exempt from registration.[212] Such a procedure would ordinarily require the cooperation of the issuer, although trading the restricted securities exclusively in the PORTAL market discussed below is an alternative, assuming that PORTAL becomes operational.

[e] Resales of Rule 144A Securities

The qualified institutional investor purchasing shares sold to it in reliance on Rule 144A has acquired restricted securities[213] and may rely on Rule 144 or Rule 144A for the resale of the securities. Rule 144, which requires a two year holding period, will be a more practicable alternative (except as to securities of certain foreign issuers) if Rule 144 is amended as proposed concurrently with the proposal of Rule 144A so as to permit the tacking of holding periods by successive purchasers of restricted securities.[214] The proposed amendment, however, specifically excludes securities of a foreign issuer which is not a reporting company at the time of the resale. As to securities of such issuer, a new holding period would commence with each Rule 144A purchase. This may mean as a practical matter that once such securities enter the Rule 144A market they cannot enter the U.S. public market if the issuer does not become a reporting

System). *Id.* However, a list of foreign issuers relying on Rule 12g3-2(b) published by the SEC, according to the author's count, included only 948 companies. *See* Securities Exchange Act Release No. 27325 (Sept. 29, 1989), 44 SEC Docket 1193 (Oct. 18, 1989).

212. Rule 144A(d)(5).

213. Rule 144A, Preliminary Note 5.

214. Proposed amendment to Rule 144(d)(1). *See* Reproposed Rule 144A Release, *supra* note 2.

company. The commencement of a new holding period each time the securities trade will make it difficult for any Rule 144A purchaser to satisfy the Rule 144 holding period requirements. The holder, however, could exit the private market by selling the securities in reliance on Rule 906 in the offshore market in which the security trades, if there is one.[215]

The special regimen for non-reporting foreign issuers suggests that the staff believes that the information available relating to such issuers is less informative than information available relating to non-reporting U.S. issuers. Rule 15c2-11 requires that before dealers can submit quotations in the "pink sheets" relating to a non-reporting issuer that has not made a recent registered or Regulation A offering the market maker must have in its files certain basic information pertaining to the company and make it reasonably available upon the request of a prospective purchaser. There is no requirement that such companies file any information with the Commission. A non-reporting foreign issuer whose securities are traded in the "pink sheets" in most instances is relying on the Section 12g3-2(b) exemption and will have filed and continue to file its home country reports with the Commission. In addition, a market-maker submitting quotations to the "pink sheets" must have in its files the information filed by such foreign issuer with the Commission and make it reasonably available upon the request of a prospective purchaser.[216] Both disclosure systems are seriously flawed, and it is illusory to believe that one is better than the other.

If Regulation S continues to be treated as involving shares issued in transactions not involving a public offering, presumably the holding period of the initial purchaser for purposes of Rule 144 will run from the date of acquisition by the initial purchaser from the issuer. If the securities are resold in reliance on Rule 144A or in successive Rule 144A transactions, the holding period will also run from that date if Rule 144(d)(1) is amended except as to securities of foreign issuers which are non-reporting companies at the time of the sale. Presumably, to the extent purchasers in a Regulation S distribution can resell the securities after the expiration of the restrictions imposed by Regulation S,[217] the purchaser in a Rule 144A transaction should be able to do so as well. In that event, reliance would be placed on Section 4(1) in connection with the resale rather than the Rule 144A safe harbor. The parties to such a transaction will have an interesting dilemma since the seller in order to have the benefit of Rule 144A must notify the buyer that the seller may rely on Rule 144A. In that event, the buyer may be reluctant to purchase the securities if it assumes that the Section 4(1) exemption is available. If it is in fact a Rule 144A transaction, the buyer must conform with the Rule 144 two year holding requirements.

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215. *See* §7[b] *supra*.
216. Rule 15c2-11(a)(4).
217. *See* discussion at §7[c] *supra*.

[f] Rule 144A and Regulation S in Tandem

Rule 144A, if adopted, although broader in application, will work in tandem with Regulation S and to a limited extent will expedite the purchase of foreign securities by U.S. institutional investors. This may occur in several ways. Foreign issuers may place their securities directly with U.S. institutional investors as a private tranche of a public offering being made outside the United States in reliance on Regulation S. A dealer participating in the offshore distribution may purchase part of the issue for distribution to Rule 144A purchasers. Rule 144A is generally not an exemption for the private placement itself, since it excludes issuers and dealers from the provisions of Rule 144A which provides that one selling in reliance on Rule 144A shall not be deemed an underwriter for the purposes of Section 4(1). However, Rule 144A provides that a dealer selling securities in conformity with Rule 144A is not deemed a participant in a distribution within the meaning of Section 4(3)(C) and is not deemed to have offered the securities to the public within the meaning of Section 4(3)(A) which should provide a Section 4(3) exemption for its transactions as a dealer. The nature of the offering should assure that the dealer is not an underwriter for purposes of Section 4(1). This does not, however, assure the issuer of an exemption and presumably it would have to rely on a conventional Section 4(2) exemption under these circumstances, which it may be reluctant to do notwithstanding Preliminary Note 6 which provides that the fact that purchasers of securities from the issuer may purchase with a view to reselling the securities under Rule 144A does not affect the availability to the issuer of the Section 4(2) exemption. The issuer, nonetheless, has made a private placement to the ultimate purchasers which conceptually would not be available if they did not have access to appropriate information relating to the issuer. Further, assuming a violation by the issuer, the dealer, conceivably, may be a secondary violator of Section 5 notwithstanding the dealer exemption.[218]

The dealer alternatively could act as a placement agent for the issuer making the offshore distribution and sell the private tranche to a larger prospective group of institutional and other accredited investors under Regulation D. The Regulation D offering in the United States will not be deemed integrated with the public offering offshore.[219] It is not clear, however, that foreign issuers will be as willing to utilize Regulation D as they have not rushed to do so in the past. There appears to be a misconception as to the complexity of the documentation required under Regulation D vis a vis Rule 144A. In fact, no disclosure document is required under Regulation D if all the purchasers are accredited investors which can be assured if the offering is made only to institutional investors.[220] It

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218. *Cf.* United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968), *cert. denied,* 394 U.S. 946 (1969).

219. *See* Rule 502(a) NOTE.

220. Rule 502(b)(1).

will, however, be necessary for the issuer to file a Form D and to adopt appropriate restrictions on resales. The availability of Rule 144A for resales and the potential for a liquid secondary market in privately placed securities that Rule 144A promises should minimize this problem. This could very well prove to be the principal impact of Rule 144A in encouraging offshore issuers to offer securities privately in the United States.

On the assumption that most of the foreign issuers that will be inclined to tap the U.S. private placement market will desire to avoid registration and reporting under the Exchange Act, the provisions of Rule 144A and Rule 144(d)(1), discussed above, applicable to non-reporting foreign issuers may serve as a deterrent to the placement of equity securities if securities of the same class are traded or are likely to be traded in the "pink sheets." The additional restrictions are particularly obnoxious because they are applicable not only to the initial Rule 144A transaction, but to subsequent Rule 144A resales as well. This is likely to result in Rule 144A purchasers demanding a severe discount because the securities have less ability to exit from the private placement market than securities of U.S. issuers.

Rule 144A should facilitate distributions made by foreign issuers in reliance on the category 3 safe harbor of Regulation S for equity securities of non-reporting foreign issuers with SUSMI. Domestic U.S. institutional investors which do not have a foreign affiliate could not purchase in the primary distributions. The foreign purchasers, however, will be subject to a twelve month restriction on sales to U.S. persons or in the United States in the absence of an exemption. During the period of such restrictions, the securities can be sold under Rule 906 to U.S. persons if the conditions of Rule 144A are complied with, including transactions in the United States with qualified U.S. institutional investors. The certification provisions of the category 3 Regulation S safe harbor specifically contemplate such resales.[221] The institutional purchaser, however, presumably would be acquiring restricted stock for purposes of Rule 144. If the foreign issuer does not become a reporting company, under the proposed amendment to Rule 144(d)(1) such purchaser would not only have a two year holding period from the date of acquisition but any subsequent qualified institutional purchaser from the foreign issuer would have a two year holding period commencing with the date of its acquisition. The probabilities under such circumstances are that the purchaser would be looking to a resale of the security on a foreign stock exchange or in a DOFSM.

[g] The PORTAL Market For Rule 144A Sales

The NASD has proposed a closed market which would deal exclusively in securities traded in reliance on the Rule 144A exemption.[222] The

221. Rule 905(c)(3).

222. *See* Securities Act Release No. 27470, 54 Fed. Reg. 49164 (Nov. 29, 1989) [herein-

computerized screen based market, to be known as the PORTAL market, will be available for both primary offerings and secondary trading. Since Rule 144A is not available as an exemption for issuers, and since only qualified institutional buyers and dealers are participants in the contemplated system, this apparently assumes that Rule 144A will be available for dealers purchasing a tranche of a private offering or an offering distributed pursuant to Regulation S.[223] The NASD has proposed establishing a number of safeguards to assure that securities traded within PORTAL involve transactions exempt under Rule 144A except as to the informational requirements of the Rule which would be the responsibility of the seller. The proposal also assumes responsibility for policing the exit of securities from the system.[224] This should be no great burden if Rule 144 is available for the resale of the security in the public trading markets as dealers have well established procedures for handling such transactions and for delivering a clean certificate. Nor will it be a problem if a registration statement is filed covering the exiting securities. It could be a significant burden, however, if the resale into the U.S. issues after the end of the Regulation S restriction period discussed at §7[c] are not clarified. The fact that such ambiguities are likely to create inefficiencies for the PORTAL market should provide an incentive for the staff to remove the uncertainties.

§9 Convertible Securities

There is no definition in Regulation S of a debt security, raising the issue of whether convertible debt securities are debt or equity and reviving old conceptual differences as to whether such securities are one security or two securities.[225] As discussed below,[226] convertible securities are

after the "PORTAL Release"]. *See also* discussion at *supra* note 9.

223. *See* discussion, *supra* note 218.

224. *See* PORTAL Release, *supra* note 222.

225. Prior to the adoption of Rule 144, similar conceptual problems existed with respect to privately placed convertible debentures. If the Section 4(2) exemption was available for the private placement of the debentures, arguably the Section 3(a)(9) exemption of the Securities Act for an exchange offering by an issuer with its own security holders exempted the conversion. The Commission, however, took the position that Section 3(a)(9) exempted the conversion, but not the resale of the underlying security which had to find its own exemption. Crowell-Collier Publishing Co., Securities Act Release No. 3825, [57-61 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶76,539 (Aug. 12, 1957). Rule 155 codified this position. Securities Act Release No. 4248, [1957-61 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶76,710 (July 14, 1960). Rule 144(d)(4)(B), however, superseded Rule 155 and takes essentially a one-security approach providing for a single holding period which commences with the acquisition of the convertible debenture. Rule 144 should be applicable with respect to resale of securities distributed offshore to the extent reliance is placed on the Rule so after a two year holding period either the convertible debenture or the underlying common stock could be resold in compliance with the conditions of the Rule. It does not resolve, however, the issue of whether the Regulation S safe harbor is available and when the underlying securities can be resold in reliance on Section 4(1) prior to the expiration of the Rule 144 holding period.

226. *See infra* note 236.

probably equity securities for most purposes,[227] and such securities may be debt for the purpose of determining the aggregate debt securities held by U.S. persons in connection with the determination of whether there is SUSMI for the purpose of a debt offering.[228] It does not, however, necessarily follow that a separate determination would have to be made as to whether there was a SUSMI with respect to the convertible debt security and the underlying equity security. If a convertible debenture is deemed a single security, the distinction is not an important one with respect to reporting companies since, whether debt or equity, it will be in category 2 and subject to the same offering and transaction restrictions. In the case of a non-reporting U.S. issuer, whether debt or equity, it will be a category 3 security. However, as to such issuers, the period and nature of the transaction restrictions depends upon whether the security is a debt or equity security. In the case of a non-reporting foreign issuer with SUSMI, if a convertible debt security is debt it is in category 2; if equity, it is in category 3 and subject to the more rigorous transaction restrictions of that category.

If the convertible debt security is both a debt security and equity security, there will be important different consequences in all of the situations described. In that event, there would be transaction restrictions not only with respect to the convertible security, but also as to the underlying security. In the case, for example, of a convertible debenture issued by a non-reporting foreign issuer, it would be necessary to first determine whether there is SUSMI with respect to both debt and common stock. Assuming there was SUSMI with respect to both, the convertible debenture would be in category 2 and the underlying common stock would be in category 3. If there was SUSMI as to the common stock, but not as to the convertible debt, the convertible security would be in category 1 and the underlying common stock would be in category 3.

The staff's position historically in applying Release 4708 has been similar to Rule 155[229] in regarding a convertible security as two securities and limiting the Section 3(a)(9) exemption to the conversion and not to the resale of the underlying security which must be registered or find its own exemption prior to resale. International Telephone and Telegraph (ITT) in September of 1972 sold $50 million of convertible debentures in the Eurobond market in reliance on Release 4708 adopting a ninety day lock-up as to the debentures. The conversion price was at a premium of approximately forty percent above the current market price of the common stock at the time of distribution.[230] The underlying common stock

227. Section 3(a)(11) of the Exchange Act and Rule 3a11-1 adopted and Rule 405 adopted under the Securities Act all provide that securities convertible into equity securities are equity securities, but these definitions are not specifically incorporated into Regulation S.

228. *See* §6[c].

229. *See supra* note 225.

230. *See* Int. Tel. & Tel. Corp., SEC No-Action Letter, [1973 Transfer Binder] Fed.

was listed on the New York Stock Exchange and the issuer was, therefore, a reporting issuer. Counsel for ITT requested a no-action letter asserting that Section 3(a)(9) would exempt the conversion and the resale of the underlying shares. The staff replied that based on counsel's opinion it would recommend no action if the convertible debentures were converted into common stock without registration in reliance on Section 3(a)(9). The letter, however, went on and stated: "[W]e cannot agree that the exemption provided in said Section 3(a)(9) would cover resales by the holders of the common stock received upon such conversion. Any such resales would require registration under the Act absent some other available exemption." Counsel then came back with the argument that resales would be exempt under Section 4(1) as transactions not involving an issuer or underwriter. The staff responded that notwithstanding "the facts and arguments presented, we are unable to conclude that this Division would not recommend appropriate action to the Commission if the subject debentures or the underlying stock were to be distributed in the United States without registration under the Securities Act of 1933." The ITT letter, nonetheless, represented a concession from the position previously asserted that the underlying securities had to be registered prior to conversion.[231]

A $60 million offering by Sperry Rand (Sperry) of convertible debentures in the Eurobond market in February of 1973 posed substantially identical issues.[232] The debentures could not be converted until March of 1974. Counsel to Sperry expressed the opinion that the conversion would be exempt under Section 3(a)(9) and the shares could be resold in reliance on the Section 4(1) exemption. The staff gave essentially the same response; no action would be recommended with respect to the conversion, but no views were being expressed as to when the debentures or the shares underlying the debentures could be resold in the United States. In a number of subsequent convertible debenture offerings made in reliance on Release 4708, the debentures were subject to tight lock-up procedures and provision was made for the registration of the common stock prior to conversion apparently to provide the holders with the ability to resell the underlying shares.[233]

The Proposing Release, however, sends some different signals. A footnote to the Proposing Release states that a convertible security is an equity security unless it cannot be converted into the underlying security until the expiration of the restricted period.[234] The Proposing Release

Sec. L. Rep. (CCH) ¶79,462 (July 27, 1973).

231. *See* California Business Communications, Inc., SEC No-Action Letter (Aug. 9, 1972), in which the staff stated: "[I]t is our opinion that the underlying shares must be registered sometime prior to their issuance resulting from the conversion of the debenture."

232. Sperry Rand Corp., SEC No-Action Letter (March 1, March 13, 1974).

233. *See, e.g.*, Ni-Cal Finance N.V., SEC No-Action Letter (April 30, 1984); Fairchild Camera and Instrument Corp. Int. Finance, N.V., SEC No-Action Letter (Nov. 15, 1976).

234. Proposing Release, *supra* note 2, at 89,139 n.122.

also states that conversion would ordinarily "be exempt from registration under §3(a)(9)."[235] Further, the Proposing Release specifically states that the restricted period would be restricted only for the remainder of the applicable restricted period that applied to the convertible securities.[236] This sounds like a single security theory and an adaptation of the Rule 144 treatment of convertible securities. One confusing aspect of this regulation by release rather than rule is that the no-action letter cited for the proposition that the convertible debenture is an equity security[237] is one of a series of letters taking the position that Section 3(a)(9) does not exempt the resale of the underlying security.[238]

This approach has the virtue of simplifying the application of Regulation S to convertible debentures, making for a nice tidy package. SUSMI for foreign issuers of a convertible debenture would probably be determined on the basis of whether it existed with respect to the underlying common stock. If SUSMI exists and the issuer is a non-reporting company, the convertible debenture as an equity security would be in category 3 and the twelve month restricted period and related restrictions applicable to category 3 equity restricted securities would come into play.[239] The restricted period applicable to the underlying security, however, would commence with the completion of the distribution of the convertible security.

If the security could not be converted until the end of the transaction restriction period, it would be a debt security. SUSMI of a foreign issuer would be determined on this basis. If there was no SUSMI for its debt securities, it would be in category 1; otherwise it would be in category 2. The appropriate Regulation S restricted period which determines the period for which the securities must not be convertible in order to be debt, is "the restricted period, if any, applicable to the equity securities of the issuer."[240] There are no transaction restrictions for category 1 securities of certain foreign issuers provided there is no SUSMI. But whether there is SUSMI may depend upon whether the convertible securities are debt or equity. The reasoning, therefore, becomes circular. One way to break that circle is to determine whether there is SUSMI for the equity securities of the issuer and if there is not to assume that it is a debt security. In that event, applying the foregoing criterion literally, the securities can be immediately convertible since there are no restrictions applicable to its equity securities. If there is SUSMI as to the equity securities of a foreign issuer, the restricted period is forty days as to a reporting company and twelve months as to a non-reporting company. In order to be classified as debt, therefore, the securities of a reporting company could not be con-

235. Proposing Release, *supra* note 2, at 89,137 n.113.
236. Proposing Release, *supra* note 2, at 89,137.
237. Sperry Rand Corp., SEC No-Action Letter (March 1, 1974). *See supra* note 232.
238. *See supra* note 230.
239. *See* §6[f].
240. *See* Proposing Release, *supra* note 2, at 89,139 n.122

verted for forty days and those of a non-reporting company for twelve months. The same analysis (i.e., non convertible for forty days if a reporting company and twelve months if a non-reporting company) would be applicable to convertible securities issued by a U.S. company.

The foregoing suppositions based on the Proposing Release are all premised on the assumption that the Section 3(a)(9) exemption is otherwise available. In order for the Section 3(a)(9) exemption to be available, no commissions or other remuneration can be paid for soliciting the exchange. If the exemption is not available, the Proposing Release provides that the conversion will be treated as if it involved the exercise of a warrant.[241] Further, this analysis, if correct, although extremely helpful in determining the transaction restrictions that have to be imposed and providing a blue-print for construction of the conversion terms of the convertible debenture, does not necessarily resolve the issue of whether the securities acquired on conversion can be resold in reliance on Section 4(1) or for that matter, whether the convertible securities can be sold in reliance on Section 4(1). The problem with respect to resales in the United States of the convertible debentures is the same as that discussed above.[242] The problem is somewhat different with respect to the underlying securities, which, for example, assuming that they are not converted until after the expiration of the restricted period, the seller may attempt to resell on a U.S. stock exchange the day following acquisition from the issuer since there is no separate restricted period for the underlying securities. The niceties of the Section 4(1) arguments this scenario might produce are likely to have a deja vu ring.

§10 WARRANTS

Regulation S does not work well with respect to warrants or convertible securities that would not have the benefit of the Section 3(a)(9) exemption. This is not surprising as a similar dichotomy exists with respect to convertible securities that are registered and warrants that are issued with a debt security, both of which are registered. Once a registered public offering of convertible securities is completed, that is the end of the matter for the conversion is exempt under Section 3(a)(9) and historically Section 4(1) has been available for the resale of the underlying shares. In the case of warrants issued as part of a unit consisting of debt and warrants to purchase common stock, if the warrants are presently exercisable, there is a continuing offering of the underlying securities and a registration statement covering the underlying shares has to be kept in effect for the life of the warrants at least if the warrants are "in the money" (that is, a favorable relationship of the exercise price to the market price raises the likelihood the warrants will be exercised).[243] If the warrants are issued

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241. Proposing Release, *supra* note 2, at 89,137, n.114.
242. *See supra* note 230.
243. *See* SFCL, *supra* note 58, §7.24[1].

by a foreign issuer and neither the warrants nor the debt security have a SUSMI, the Regulation S category 1 safe harbor would permit the offering without restrictions on either security. The question is whether this would be true in the event of an overseas domestic offering. To be in category 1 the offering would have to be made in the issuer's home country. In that event, however, there may be a strong likelihood that the underlying securities will be resold immediately in the United States and the underlying security (as distinguished from the unit) may not satisfy the requirement that it be "made in accordance with customary local practices."[244] For securities in any other category there will be a restricted period. The offer of the underlying securities is a continuous one that is not completed until all the warrants are exercised or expire. The restriction on sales to U.S. persons or in the United States would, therefore, remain in effect throughout the exercise period and for the specified restricted period that commences with the completion of the offering. The Proposing Release states: "Generally, the safe harbor of Regulation S would not be available for the issuance of securities on the exercise of warrants to a U.S. person."[245]

The Proposing Release refers to the no-action letter relating to *Sears Overseas Finance N.V.*[246] as reflecting this position. In *Sears*, the company offered offshore units consisting of Notes in the principal amount of $100 million and warrants to purchase other notes with a different maturity date in the principal amount of $200 million. The Notes originally issued were subject to conventional lock-up provisions for ninety days and the definitive notes and warrants were not delivered to purchasers until the expiration of the ninety days and certification of non-U.S. ownership. The warrants included a legend that they could not be sold to or exercised by any national or resident of the United States. On exercise of the warrants, the holder was required to certify that he was not a U.S. national or resident and undertake not to resell the notes received on exercise of the warrants for ninety days to a U.S. national or resident. No lock-up procedures, however, were adopted as to the notes received on exercise of the warrants. The staff's no-action letter included the usual statement that "no view" was expressed as to when the notes could be reoffered or resold in the U.S. or to citizens or residents of the U.S. without registration under the Securities Act. Although not explicit in this regard, the implication of the Proposing Release discussion of warrants[247] is that the securities received on exercise of the warrants would be subject to the relevant transfer restrictions to U.S. persons or in the United States in order for a safe harbor to be available. To this extent, it goes beyond *Sears* as to certain securities since, it would, for example, with respect to warrants to purchase a debt security of a non-reporting U.S.

244. Rule 902(h).
245. Proposing Release, *supra* note 2, at 89,133 n.93.
246. SEC No-Action Letter (June 11, 1982).
247. *See supra* note 245.

issuer require the use of a global certificate in connection with the issuance of the debt securities.[248] Since the restriction remains in effect for forty day after the completion of the offering, which would not be until 40 days after the expiration of the warrants, warrant holders exercising well in advance of the expiration date would go for an extended period of time without a definitive certificate relating to the security acquired on exercise of the warrants. Similarly, in the case of category 3 equity securities, warrant holders exercising the warrants early would be subject to the restrictions for a period in excess of twelve months. Under these circumstances it would appear imperative for the securities to trade on a foreign stock exchange to provide holders on the exercise of the warrants a market in which they could resell the securities under Rule 906.[249]

§11 Extraterritorial Reach of the Fraud Provisions

The liberal attitude of the SEC relating to the sale of unregistered securities outside of the U.S. does not mean that the U.S. securities laws have no application to transactions effectuated within the scope of Release 4708 or Regulation S. The potential extraterritorial scope of the fraud provisions of the U.S. securities laws is as broad as the definition of commerce, which includes the use of any means or instrumentality of commerce between a state of the United States and a foreign country.[250] The Second Circuit in particular has gone very far in finding subject matter jurisdiction with respect to the fraud provisions of the securities laws as they apply to sales made to non-nationals of the United States if the jurisdictional means have been used and significant activities relating to the offering have taken place in the United States. Although the Second Circuit conceptually distinguishes between mere preparatory acts which have taken place in the United States (no subject matter jurisdiction) and acts occurring in the United States which directly caused the loss (subject matter jurisdiction), as a practical matter, the preparation of the prospectus (or other disclosure document) of a U.S. issuer has to take place primarily in the United States, in which event it appears that the fraud provisions are applicable.[251] It does not appear (as to private placements) that the failure to make any disclosure will avoid jurisdiction since a culpable failure to act which occurs in the United States can be the basis for subject matter jurisdiction.[252]

Judge Robert Bork, then sitting on the Court of Appeals for the District of Columbia, approached the question of extraterritoriality from a

248. *See* §6[f].

249. *See supra* §7[a].

250. 15 U.S.C. §77b(7); 15 U.S.C. §78c(a)(17).

251. *Compare* Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir. 1975), *with* ITT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980).

252. Bersch v. Drexel Firestone, *supra* note 251, at 993. *See also* Continental Grain (Australia) PTY, Ltd. v. Pacific Oilseeds, Inc., 592 F.2d 409 (8th Cir. 1979).

slightly different perspective.[253] The plaintiffs were citizens of West Germany who bought securities consisting of interests in a West German limited partnership that contemplated investing in U.S. real estate. Arthur Anderson & Co. GmbH (GmbH), a West German limited liability corporation, prepared a report relating to the "entire plan" and the defendant, Arthur Anderson & Co. (AA-USA) furnished information to GmbH to be included in the report. The information was alleged to be false and misleading. AA-USA challenged the subject matter jurisdiction of the U.S. courts.

Judge Bork surveyed the case law in the other circuits, referring to the Second Circuit's position as evidenced by *Bersch* as more restrictive than the views of the Eighth Circuit in *Continental Grain*[254] and the Third Circuit in *Kasser*.[255] It is sufficient, under *Continental* with respect to the sale of securities by foreigners to foreigners that the conduct of the defendant in the United states "was in furtherance of a fraudulent scheme and was significant with respect to its accomplishment."[256] The Third Circuit's test in *Kasser* "where at least some activity designed to further a fraudulent scheme occurs within this country,"[257] is even "more permissive."[258] *Kasser*, however, may be appropriate (although the court noted it was not deciding that issue) since it involved an action by the SEC which "is a responsible governmental agency" and can take into account the policy concerns of the State Department in initiating an action involving foreign contacts.[259] To a degree all of the decisions are policy oriented since the statute is not explicit and there is no relevant legislative history. Judge Bork, if writing on a clean slate, might have been inclined "to doubt that an American court should ever assert jurisdiction over domestic conduct that causes loss to foreign investors."[260] In view of "the Second Circuit's preeminence in the field of securities law," and out of a "desire to avoid a multiplicity of jurisdictional tests," the court opted for adopting the Second Circuit test since it opened up the door to American courts the least.[261] The court then applied its restated version of that test as one that required that the acts of the defendant committed in the United States satisfy all the elements of a Rule 10b-5 claim other than reliance and damages.[262] The court concluded that since the defendant did not furnish information used in any disclosure document, but merely furnished it to another party who in turn used the information, that the

253. Zoelsch v. Arthur Andersen & Co., 824 F.2d 27 (D.C. Cir. 1987).
254. Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds, Inc., 592 F.2d 409 (8th Cir. 1979).
255. SEC v. Kasser, 548 F.2d 109 (3d Cir.), *cert. denied*, 431 U.S. 938 (1977).
256. 592 F.2d at 421.
257. 582 F.2d at 114.
258. 824 F.2d at 31.
259. *Id.* at 33 n.3.
260. *Id.* at 32.
261. *Id.*
262. *Id.* at 33.

defendant's acts were not in connection with the purchase or sale of a security.[263] Since one of the elements of Rule 10b-5 was not established as to the defendant, subject matter jurisdiction did not exist.

The court invited a comparison with the leading Rule 10b-5 case on the issue of whether misrepresentations were made in connection with the purchase or sale of a security in which the test is whether "assertions are made . . . in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media . . . ."[264] Judge Bork, however, appears to have disregarded the allegations of the complaint that AA-USA knew that the information it furnished would be included in the report and relied upon by investors by referring to the "private" nature of the communication. Similarly, he glossed over *Texas Gulf Sulphur* by contrasting the private communication with the use of the "means of the financial media," disregarding the fact that the "e.g." in the quote reflected that the financial media was illustrative rather than exhaustive and ignoring the end use of the information. He also reinforced his views by reference to Section 30(b) of the Exchange Act which excludes the application of the Act to conducting a business in securities outside of the United States unless the Commission explicitly adopts rules necessary or appropriate to prevent evasion of the Act. He drew from this the inference that Congress intended to limit the extraterritorial application of the Act. What he fails to note is that this provision deals with the regulation of the securities business outside the United States; that is, activities of broker-dealers. Chief Judge Wald, in concurring, disassociated herself from the rationalization of the opinion, concluding that under any approach the misrepresentations alleged were insignificant and so indirectly related to the fraudulent scheme that federal jurisdiction did not exist.

Where AA-USA issued certified consolidated financial statements for DeLorean Motors Co. and its subsidiaries, the field work for which, it contended, was largely done in the United Kingdom and Ireland, the district court, nonetheless, refused to dismiss for lack of subject matter jurisdiction.[265] The purchaser-plaintiff was an agency of the British government and the securities sold consisted of preferred stock of a UK subsidiary. In addition to concluding that there was at least a dispute as to the amount of work done outside of the United States on the audits, AA-USA also, since it certified the statements, had a duty to supervise the work under generally accepted auditing standards. Further, the close relationship of the American parent and its foreign subsidiary, based on *Cornfeld*, permitted the court to regard the securities as being "in substance" American securities rather than foreign securities.[266]

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263. *Id.* at 34.

264. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968). *See* SFCL, *supra* note 58, §9.10[1].

265. Dept. of Economic Dev. v. Arthur Andersen & Co., 683 F. Supp. 1463 (S.D.N.Y. 1988).

266. *Id.* at 1471.

§12 CONCLUSION

The adoption of Regulation S and Rule 144A will stimulate offshore distributions, will provide a less regulated access to the U.S. market to foreign issuers, will enhance the liquidity of securities issued in the private placement market, and will enhance the access of U.S. institutional investors to issues of securities by foreign companies. The impact, however, is likely to be a modest one in all of those areas notwithstanding the predictions for dramatic change.

U.S. and other issuers have been distributing huge amounts of securities in the Eurobond market for well over a decade, with the U.S. issuers using lock-up procedures to prevent flowback and many foreign issuers oblivious to the theoretical subject matter jurisdiction of the SEC. Regulation S will make the restrictions somewhat less cumbersome, should improve the efficiency of this market and, hence, make it at least marginally more attractive than presently. Unfortunately, Regulation S does not say point blank that once the safe harbor restricted period has expired the securities can be resold to U.S. persons and in the United States. The ambiguities in this area will continue to be of concern although they are greatly alleviated by the fact that the securities can be resold at any time if the securities are traded in an appropriate foreign securities market.

The extent to which foreign issuers will be more likely to offer securities in the United States is more a matter of perception than rule-making. Rule 144A does not provide an exemption for issuers making a private placement although it will facilitate purchases of a block of securities from an issuer by a dealer which can rely on Rule 144A in connection with the resales. Nor does Rule 144A provide greater flexibility as to the disclosure document that can be used in a private placement than Regulation D. Regulation D does not require the use of any disclosure document in sales to accredited investors.[267] A foreign issuer can use its foreign prospectus, assuming it complies with the fraud provisions, or it can use no disclosure document in an offering of a private tranche made in reliance on Regulation D. If the assumption is that the dealer will buy a block from the foreign issuer and distribute it in the United States under Rule 144A, the issuer must still be concerned about its exemption.[268] Reliance on Regulation D rather than Section 4(2) appears to be advisable and would permit a much broader market for the primary distribution since the offering could be made to any accredited investor.[269] In that event, Rule 144A would add liquidity by providing a secondary market

267. Rule 502(b)(1).

268. *See* discussion at *supra* note 218.

269. The PORTAL market, however, would not be available for the primary distribution if made to accredited investors who are not qualified institutional purchasers under Rule 144A. Purchasers that are Rule 144A qualified could go directly into PORTAL to resell the securities and non-qualified purchasers could access PORTAL for resales through a broker with access to PORTAL. *See* discussion, *supra* note 9.

which would not be inconsistent with the resale restrictions of Rule 502(d). It would be necessary for the issuer to file a Form D, which is the simplest of procedures.[270] There may be an assumption that if the securities are purchased by the dealer and resold in reliance on Rule 144A that only the dealer will have Section 12(2) liability for misrepresentations in the selling materials.[271] This issue has not been fully resolved and appears to be a risky assumption from the standpoint of the issuer.

Regulation S will facilitate purchases of securities distributed offshore, including foreign securities, by U.S. institutional investors who organize a separate subsidiary based offshore since such subsidiaries will not be U.S. persons. Those that do not have a subsidiary will be able to purchase securities distributed offshore by foreign issuers relying on the category 1 safe harbor, but only if the transaction (including the offer) takes place offshore. This will be no easy matter for an institutional investor that has neither an offshore subsidiary nor an offshore presence. It is further complicated by the fact that there can be no directed selling effort in the United States; hence, there is a problem as to how such institutional investors will become aware of the offering. Qualified U.S. institutional investors can effect Rule 144A transactions with the original purchasers in a Regulation S distribution. The primary way most U.S. institutional investors will participate is by purchasing the securities distributed offshore in the organized offshore securities market in which they are traded and by purchasing securities of foreign issuers that are placed privately in the United States.

A principal impact of Regulation S and Rule 144A will be to significantly enhance the liquidity of the secondary market in securities privately placed in the United States. This will be particularly true once the PORTAL market is in place. Institutional investors will be encouraged to purchase securities privately placed in the United States by foreign issuers because they are likely to have an outlet before the expiration of the Rule 144 two year holding period through PORTAL or a foreign trading market. Purchasers of privately placed domestic securities will have the same outlets, but it is less likely that there will be a foreign market for the security.

There has been a tendency to overlook the significance of the General Statement to the effect that offshore offers and sales of securities are not subject to the registration provisions of Section 5.[272] Although one obviously prefers to rely on a safe harbor, the General Statement may be useful in situations in which the safe harbor is unduly restrictive. This might be the case, for example, with respect to the resale of shares underlying

270. *See* SFCL, *supra* note 58, §4.05[7].

271. *See* Collins v. Signetics Corp., 605 F.2d 110 (3rd Cir. 1979). *See also* Pinter v. Dahl, 486 U.S. 622, (1988). *But see* Abell v. Potomac Ins. Co., 858 F.2d 1104, 1115 (5th Cir. 1988) ("everyone who invested in the initial offering bought from the underwriters and the issuer"). *Cf.* SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980).

272. *See* § 5.

warrants in which the restricted period is measured from the expiration of the exercise period rather than when the warrant is exercised because the offering of the underlying shares is a continuous offering. The existence of the General Statement also affords the basis for attempting to obtain a no-action letter in situations in which Regulation S did not get everything right in the first instance. It may also be of some comfort with respect to resales in the United States after the end of the restricted period as to which Regulation S is silent.

A frustrating aspect of both proposed Regulation S and Rule 144A is the tendency to regulate by the legislative history reflected in the proposing and reproposing releases rather than in the regulation. A consequence is that one must scour the releases (and particularly the footnotes) for important nuances not covered by the proposed rules. One purpose of this article has been to perform that function for the reader, but someone with a specific problem will have to repeat that process to be sure that nothing has been overlooked.

The possible combination of transactions that will arise as the result of the interrelationship of Regulation S and Rule 144A is almost limitless, as are the various scenarios relating to offshore distributions that will be subject to Regulation S. Part II of this article will approach Regulation S and Rule 144A from the vantage point of specific offerings and transactions rather than in general abstract terms.