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Searching for Liquidity: United States Exit Strategies For International Private Equity Investment

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SEARCHING FOR LIQUIDITY: UNITED STATES EXIT STRATEGIES FOR INTERNATIONAL PRIVATE EQUITY INVESTMENT

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I. OVERVIEW

Over the last decade, tremendous economic and political change around the world has opened the door for United States investors seeking opportunities beyond the domestic market. The crumbling of the wall that separated Eastern Europe and Russia from the West, the adoption of free market and democratic principles in much of Latin America, and the blossoming of Asia as an economic power all are contributing to the larger phenomenon known as the "globalization" of financial markets.¹

This analysis delves into the role of the private equity market in extending the reach of United States investors' opportunities in both developed countries and increasingly, the world's emerging markets. Today, recognition of these opportunities is only beginning to crystallize as investors develop a level of comfort in acquiring non-American securities.² If the last five years serve as a prologue to the next five, then this level of interest in foreign securities among United States investors should grow exponentially and international private equity investing will blossom.³

As one form of investing in a foreign company, international private equity investment holds the promise of becoming a preferred in-

1. See Edward Greene et al., *Hegemony or Deference: U.S. Disclosure Requirements in the International Capital Markets*, 50 BUS. LAW. 413, 413 n.1 (1995) (describing the "globalization" of the world's capital markets as the increasing interconnectedness of the various domestic markets by the capital raising activities of companies and the purchasing activities of investors, primarily institutional investors).

2. See J. Carter Beese, Jr., *Reengineering Regulation: Maintaining the Competitiveness of the United States Capital Markets*, 18 WASH. Q. 133 (1995), available in LEXIS, News Library, Curnews File (discussing United States Treasury Bulletin statistics on aggregate United States purchases and sales of securities in foreign markets). Illustrative of the emergence of foreign equity investment by United States investors is the fact that in 1980, American investors purchased \$17.9 billion of foreign securities. See *id.* In 1994, United States investors purchased more than \$850 billion in foreign securities. See *id.*

3. See *Wall Street's Global Equity Boom*, EUROWEEK, Nov. 1996, at 47, para. 137, available in LEXIS, News Library, Abisel File ("If the trends of the past five years are anything to go by, the percentage of funds allocated to foreign stocks is sure to continue increasing—perhaps not as fast as underwriters and issuers would like, but enough to ensure that many hundreds of billions of dollars of new capital becomes available to foreign companies.").

vestment option for many sophisticated United States investors.⁴ Conversely, for the foreign company, such investment offers a route by which it may access the world's capital markets for the first time.⁵ Ensuring that international private equity investment is successful rests in large part on the availability of viable exit strategies for the investor.⁶ This inquiry focuses on the structures and strategies which will help investors overcome the unique challenges posed by private equity investment and exit successfully through United States capital markets.

A. UNITED STATES INVESTOR INTEREST IN FOREIGN EQUITIES

United States investors historically have shown little interest in holding equity positions in foreign companies.⁷ However, with the dramatic growth of United States mutual funds and pension funds over the last decade,⁸ these institutional investors have begun to increase the allocation of their holdings dedicated to foreign equities.⁹ Furthermore, an increasing number of foreign companies are listing on United States exchanges,¹⁰ including companies from emerging

4. See *id.* paras. 13-19.

5. See *id.* para. 96.

6. Cf. GEORGE W. FENN ET AL., BOARD OF GOVERNORS OF THE FED. RESERVE SYS., *THE ECONOMICS OF THE PRIVATE EQUITY MARKET* 1, 17-21 (1995) (discussing investment in private equity markets). International private equity investment is characterized by taking a long-term, relatively liquid position with management responsibilities in a foreign company. See *id.*

7. See Beese, *supra* note 2, paras. 11-14.

8. See *id.* paras. 23-24 (explaining how certain institutions, such as mutual funds and pension plans, are "able to seek out and evaluate the ever-widening range of global opportunities."). In 1975, the share of the United States equity market owned through mutual funds was about four percent, a percentage that grew to almost eleven percent in 1993. See *id.* para. 35. Similarly, the amount of United States equities owned by private and public pension plans from 1975 to 1993 grew from \$132 billion to \$1.6 trillion. See *id.*

9. See *id.* para. 35.

10. See Maggie Urry, *Only in America Are Resources This Deep—The World's Biggest Economy Boasts the Most Flexible and Liquid Pools of Corporate Funding. But Foreign Issuers Have to Adapt to Suit United States Investors, Not Vice Versa*, FIN. TIMES, Feb. 1, 1996, at 33 (stating that from 1992 to 1995 the number of foreign companies that were listed on the New York Stock Exchange doubled). In order to increase the number of listings overall and to maintain United States market competitiveness in the international arena, American exchanges have actively recruited these foreign company listings. See *id.*

markets,¹¹ thereby raising their own visibility in the United States and fueling interest in other foreign issuers.

Much of this new United States investor interest in foreign equities is driven by the promise of higher returns than these investors may realize in the domestic market, as well as a recognition that investors may lower the risk in their portfolios as they diversify holdings to include foreign equities.¹² In addition to heightened investor demand, the series of high-profile privatization programs in Asia, Europe, and Latin America combined with the lack of sufficiently capitalized home country markets which prompts foreign issuers to look abroad for financing, has driven United States foreign equity investment.¹³

As a component of their overall portfolio, United States investors typically have dedicated the majority of their foreign equity investments to companies from other developed countries.¹⁴ Fostered by the success of those investments in developed countries, United States investor interest in companies from emerging markets is also beginning to increase.¹⁵ According to the International Monetary Fund, approximately \$0.50 out of every \$100 of foreign portfolio investment from industrialized countries was invested in emerging

11. See Joan Ogden & Heike Wipperfurth, *Should All Those Foreign Companies Be Listing on the NYSE?*, 10 GLOBAL FIN. 54 (1996) (observing that "[p]robably half the newcomers [to the New York Stock Exchange] hail from emerging market countries, with small, immature stock markets and insufficient capital for their needs.").

12. See Robert Bayless et al., *International Access to United States Capital Market—An AAA Forum on Accounting Policy*, ACCT. HORIZONS, Mar. 1996, at 75 (quoting Jim Cochrane, Senior Vice President for Research and Planning of the New York Stock Exchange, as noting that "American investors have discovered that by not having foreign securities in their portfolios for the last, say, 15 to 20 years, they have left money on the table. If they had diversified, they would have enjoyed high rates of return at low risk—an example of pure economic gain.").

13. See *Foreign Issuers Finding Welcome with United States Offerings*, GOING PUBLIC—THE IPO REP., INVESTMENT DEALERS' DIG., Oct. 21, 1996, para. 14, available in LEXIS, News Library, IDD File.

14. See *Wall Street's Global Equity Boom*, *supra* note 3, para. 70 (discussing a study by Technimetrics that calculated the international equities held by United States investors as rising to \$411.9 billion in the first quarter of 1996, which represented a 17.6 percent increase over international equity holdings in the first quarter of 1995). European stocks constituted about 52.7 percent of total international holdings; Asia Pacific holdings represented 24.8 percent; and Latin American investment constituted only 7.3 percent. See *id.* para. 72.

15. See *id.* paras. 24-27.

markets in 1987.¹⁶ By 1993, more than \$16 out of every \$100 in foreign investment went to companies from emerging markets.¹⁷ Additionally, Barings Securities found that net capital flows to developing country equity markets increased from \$1.3 billion in 1990 to \$14 billion in 1992 and to \$52 billion in 1993.¹⁸ United States investment in emerging market equities is in an early and encouraging stage.

B. THE UNITED STATES PRIVATE EQUITY MARKET

The private equity market is the fastest growing segment of United States corporate finance.¹⁹ According to the Board of Governors of the Federal Reserve System, over the past 15 years, the rate of growth for the private equity market has exceeded that of the United States public equity market, the bond market, and private placements of debt.²⁰

Typical investors in the private equity market²¹ include: public and corporate pension funds, which alone constitute over 40 percent of the total market; endowments and foundations; bank holding companies; wealthy individuals; insurance companies; investment banks;

16. See Enrique Carrasco & Randall Thomas, *Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crisis*, 34 COLUM. J. TRANSNAT'L L. 539, 585 (1996) (citing DAVID FOLKERTS-LANDAU ET AL., INTERNATIONAL MONETARY FUND, INTERNATIONAL CAPITAL MARKETS: DEVELOPMENTS, PROSPECTS, AND POLICY ISSUES 35 (1995)). This IMF report indicates that institutional investors from the United States, France, Germany, Japan, and the United Kingdom have invested, on average, less than one percent of their assets in emerging markets. See *id.* According to the IMF, if those institutional investors were to diversify their portfolios on the basis of actual market capitalization, the emerging markets' share of institutional portfolios would grow to 12 percent. See *id.*

17. See *id.*

18. See Beese, *supra* note 2, para. 27.

19. See FENN ET AL., *supra* note 6, at 1.

20. See *id.* The report also states that the private equity market has received little attention or analysis by the media or academic literature, due, at least in part, to the fact that information about private equity instruments is difficult to obtain because of their exemption from federal securities laws. See *id.*

21. See *id.* at 2. Consistent with the Board of Governors of the Federal Reserve System's analysis discussed, *inter alia*, in FENN, *supra* note 6, this inquiry treats both non-venture investing and venture capital investing as components of the private equity market due to close similarities in their characteristics. Some commentators treat venture capital investing and private equity investing as separate and distinct forms of non-public investing. See Jill Andresky Fraser, *A Pitch for Private Equity*, INC., Dec. 1995, at 126.

and other corporations and investor groups.²² The booming Initial Public Offering (IPO) market in the United States has rewarded these private equity investors well, and they now are seeking to diversify their portfolios and take advantage of the untapped potential in non-United States markets.²³ Additionally, intermediaries and agents involved with private placements are under pressure from other market competitors in a tight or stagnant domestic market, pushing them to look for opportunities abroad.²⁴

Private equity investment plays an important role for different types of companies: companies in their early stages, established private companies with a need for expansion financing or which have not yet been exposed to the capital markets, and companies in financial distress.²⁵ This type of financing typically is more expensive to the issuer since the risks associated with the investment and the due diligence required of investors are more extensive.²⁶ To compensate for these risks, and because private equity investments generally are not subject to the federal securities laws, investors utilize several safeguards.²⁷ First, private equity investors rely on their expertise and resources, either directly or through a qualified intermediary, to obtain and analyze information about the company.²⁸ Second, these investors structure their investment to include mechanisms that will give them influence over the company, including board representation and voting rights, the ability to control the company's access to

22. See FENN ET AL., *supra* note 6, at 49.

23. See Aimee Picchi, *LJY, Symphony and Rogers Casey to Launch International Private Equity Firm*, PRIVATE ASSET MGMT., Nov. 18, 1996, available in LEXIS, News Library, ITNews file.

24. See Randall Devere, *Though Overall Volume Is Up 46%, Private Placement Agents Find Themselves Beset by Competitors Old and New*, INVESTMENT DEALERS' DIG., Sept. 2, 1996, at 1, available in LEXIS, News Library, IDD File. In recent years, in part due to the low interest rate environment in the United States, commercial lenders have been offering credit with longer maturities, tighter spreads, and looser covenants, thereby pushing private placement agents to construct more innovative securitizations and mine for cross-border originations. See *id.*

25. See FENN ET AL., *supra* note 6, at 17.

26. See *id.*

27. See STEPHEN D. PROWSE, FEDERAL RESERVE BANK OF DALLAS, CORPORATE FINANCE IN INTERNATIONAL PERSPECTIVE, LEGAL AND REGULATORY INFLUENCES ON FINANCIAL SYSTEM DEVELOPMENT, 1996, para. 17, available in LEXIS, News Library, Abisel File.

28. See *id.*

capital in the future, and the provision to existing management of the company of a significant equity interest to ensure that their interests are closely aligned with that of the private equity investor.²⁹ Consequently, the private equity investor comes to play an important role in advising, managing, and overseeing the company. By virtue of this role, the private equity investor has the opportunity to influence the company's long-term objectives, strategies, and operations, thereby enhancing the company's attractiveness to other potential investors and that investor's ability to later liquidate its position.³⁰

II. THE CHALLENGES OF INVESTING ABROAD

Investments in foreign companies, particularly those from emerging markets, face a number of challenges that increase the risk of the investment.³¹ First, many markets in both developed and developing countries lack sufficient liquidity for the domestic issuer to make a successful offering, particularly if the company is not among the top tier of industrial conglomerates or has a short record of performance.³² Second, the United States investor purchasing securities in foreign companies also assumes currency risk, a risk not presented by investing in domestic companies. Third, many foreign companies lack the managerial expertise and culture, particularly in emerging markets, conducive to structuring an offering that will attract interest from foreign investors.³³ The convergence of these factors leads to

29. *See id.*

30. *See id.*

31. *See* VENTURE CAPITAL IN OECD COUNTRIES, FIN. MKT. TRENDS, Feb. 1996, at 15, 17 (1996) (noting that "[m]any [Organization for Economic Cooperation and Development] countries have an imbalance between venture capital investment and divestments. This indicates that while the supply of venture capital has increased rapidly, the means for exiting from these investments have been insufficient, particularly in Western Europe."). While the lack of liquidity in developing countries is more apparent, a lack of sufficient market liquidity continues to adversely impact private equity investing, including venture capital investing, in developed countries as well. *See id.* at 17-19.

32. *See* INT'L FIN. CORP., INVESTMENT FUNDS IN EMERGING MARKETS 39 (1996) (indicating that even where stock markets exist in emerging markets, many remain relatively illiquid with few market participants and a weak supporting structure). Additionally, what financing these markets can provide to companies within their home market is primarily targeted to larger companies with a history of audited accounts. *See id.*

33. *See Foreign Issuers Finding Welcome with United States Offerings, supra*

the largest challenge for the private equity investor—the *lack of a viable exit strategy*.³⁴

The nature of private equity investment, based upon making a long-term commitment to the company with the prospect of a comparatively higher return after a number of years, makes the viability of an exit strategy imperative to the success of the investment.³⁵ These exit strategies may include later taking the company public, considered the preferred route;³⁶ making the company available for acquisition by another company;³⁷ repurchase of the shares by the company;³⁸ or a secondary purchase of the equities by a third party.³⁹ The investor can utilize various strategies in an effort to mitigate the risks of international private equity investment and enhance the likelihood of realizing the promise of higher returns.

A. THE IMPACT OF FOREIGN INVESTMENT ON HOME COUNTRY CAPITAL MARKETS

Many foreign countries, particularly those with emerging economies, have concerns about the impact of foreign investment on their country's economic, political, social, and cultural development.⁴⁰ As many of these governments embrace various forms of free market principles and democratic forms of government, however, they have

note 13, para. 16. In addition to the obvious risk of currency devaluation, in the course of assessing the risks of investing in foreign companies, one IPO investor noted that, "European countries are in the dark about shareholder rights, for example." *Id.*

34. See INVESTMENT FUNDS IN EMERGING MARKETS, *supra* note 32, at 5. The International Finance Corporation promotes country, regional, and global funds investing in listed securities in emerging markets, private equity, and venture capital funds, and index and emerging market corporate debt funds. *See id.* One of the most significant challenges the IFC has faced in trying to establish venture capital funds in emerging markets has been the lack of viable exit mechanisms. *See id.*

35. See FENN ET AL., *supra* note 6, at 2, 9, 34.

36. *See id.* at 34 (explaining that a public offering of a company's shares often results in the highest valuation for the company).

37. *See id.* at 35.

38. *See id.*

39. *See id.* at 34-35.

40. See Frank Morgan, *Investment Fund Structures for Emerging Markets*, STANDARD & POOR'S REVIEW OF SECURITIES AND COMMODITIES REGULATION, Sept. 27, 1995, at 157 (discussing some concerns regarding the influence of foreign investment).

also gradually recognized foreign investment as a potentially significant contributor to their overall development.⁴¹

The infusion of foreign capital into a domestic market, particularly in an emerging economy, can have significant benefits to that market.⁴² Most importantly, the immediate impact of foreign investment is to increase the liquidity of the domestic capital market, thereby enhancing price-to-earnings ratios and decreasing the cost of raising capital for those companies.⁴³ This enhanced liquidity encourages the entry of other domestic and foreign issuers into the market, thereby further improving liquidity and enabling the market to develop.⁴⁴ Described by the International Finance Corporation as the “virtuous circle of liquidity,”⁴⁵ the effect of foreign capital infusions into the domestic market is essential to the country’s economic development in that it, *inter alia*, fosters financing for capital infrastructure, spurs higher economic growth rates, increases tax revenues, and raises export earnings.⁴⁶

Some commentators have raised concerns about the potentially detrimental impact of portfolio investment by industrialized nations on emerging economies, particularly when such investment is rapidly

41. *See id.* (commenting that countries with emerging markets rank among the best performers in the global market). Many emerging-market countries place restrictions on foreign ownership of securities. *See id.* Foreign governments often premise the legitimacy of these restrictions on their desire to maintain economic independence and to preclude perceived incursions on their right of self-determination. *See id.* These restrictions on foreign ownership of securities, specifically, may come in the form of requiring the purchaser to comply with the home country’s registration requirements, including registering with the appropriate governmental authorities, imposing limits on the amount of securities that one may acquire, limiting the voting rights of the foreign investor, limiting the foreign investor to purchasing specified classes of securities only, imposing tax penalties on foreign investors, or precluding foreign investors from purchasing securities in certain industry sectors. *See id.*

42. *See id.* (recognizing that certain emerging markets rank among the best performers in the global market when compared to developed countries).

43. *See Wall Street’s Global Equity Boom, supra* note 3, para. 5 (noting that high-profile privatization programs in foreign countries have improved the quality and liquidity of stock markets).

44. *See infra* notes 43-86 and accompanying text (regarding the increase in the volume of trading in international private equity markets).

45. *See INVESTMENT FUNDS IN EMERGING MARKETS, supra* note 32, at 51.

46. *See id.* (providing an overview of how foreign funds lead to numerous economic gains).

withdrawn due to adverse economic or political conditions.⁴⁷ The "chill" in foreign investment in Mexico and other Latin American countries following the devaluation of the Mexican peso in 1994 presents a case in point.⁴⁸ Governments may avoid the adverse impact of rapid inflows and outflows of foreign portfolio investing on emerging economies by encouraging foreign private equity investment, and in particular, venture capital investing.⁴⁹ With their characteristic illiquidity, these investments are not able to shift out of a country with the speed or ease of portfolio investments.⁵⁰ Therefore, the destabilizing and stagnating effects engendered by flights of foreign capital do not cause adverse effects to the economy of a developing nation in the way that portfolio investments can.⁵¹ In addition to the illiquidity of the investment, the self-interested private equity investor is vested in the long-term future of the country and its efforts to develop stable domestic economies with sound capital markets able to maintain access to international capital outlets.⁵² The companies from these emerging markets are also able to maintain access to much needed managerial expertise and resources, which will help to mature their growing companies. Consequently, international private equity investments may not only be advantageous to the investor and foreign company, but also to the economy's sustained development.

B. ACCESSING THE UNITED STATES CAPITAL MARKETS AS AN EXIT

The United States capital market stands out as one of the most attractive sources of financing to the foreign company.⁵³ By compari-

47. See Carrasco, *supra* note 16, at 543 (noting portfolio investments as potentially destabilizing forces).

48. See *id.* at 544 (describing the negative effects that occurred in Mexico after a rapid withdrawal of portfolio investments).

49. See *id.* (describing these long-term, illiquid investments as "relational investing").

50. See *id.* (remarking that venture capital investments are difficult to withdraw rapidly).

51. See *id.* (stating that "relational investments" act as stabilizing forces against fluctuating portfolio investments).

52. See *id.* at 544.

53. See Mark A. Saunders, *American Depositary Receipts: An Introduction to U.S. Capital Markets for Foreign Companies*, 17 FORDHAM INT'L L.J. 48, 50 (1993) (asserting various factors that make the United States an appealing market for private investors).

son with other major markets, including the United Kingdom, Germany, and Japan, the sheer size of the United States market gives it unparalleled liquidity.⁵⁴ Furthermore, the United States capital market has developed the breadth and depth of financial service providers necessary to meet diverse corporate finance needs.⁵⁵ For the international private equity investor who places primary emphasis on leverage and the liquidity of exit mechanisms, the United States market has the structure and investment culture conducive to a successful exit.⁵⁶

The comparative advantage of the United States capital market against other developed markets rests, in part, on the ability of many new, high-growth or insufficiently capitalized companies to tap the market.⁵⁷ For example, Nasdaq, the active second tier market in the United States, has enabled numerous small and mid-sized companies, both domestic and foreign, to access the capital markets for additional financing.⁵⁸ A number of foreign issuers, particularly high-tech companies, view the United States as a favorable market because United States investors are more receptive and have a better understanding of such companies than investors in their home countries.⁵⁹

54. See Joseph Grundfest, *Internationalization of the World's Securities Markets: Economic Causes and Regulatory Consequences*, 4 J. FIN. SERVICES RES. 349, 364-365 (1990). The United States, United Kingdom, and Japan all have adopted regulatory changes to their securities law schemes in recent years as a means of enhancing their attractiveness to foreign companies seeking to raise capital. See *id.*

55. See PROWSE, *supra* note 27, at 5.

56. See Lorenzo Weisman, *The Advent of Private Equity in Latin America*, 31 COLUM. J. OF WORLD BUS. 36 (1996). The author notes that only the United Kingdom market, although to a lesser extent, has the structure and culture at this point to constitute an attractive alternative. See *id.*

57. See Richard Leanard, *Foreign IPOs Leave Home to Woo United States Investors*, 7 GLOBAL FIN. 19 (1993) (stating that small, foreign-growth companies are turning to the United States equity markets to raise capital). For small and medium-sized companies in particular, the United States private equity market holds a competitive advantage to those of Germany or Japan. See PROWSE, *supra* note 27, para. 5. "The bottom line is that there is no good new-issues market in Europe for small-cap growth companies," according to David Weild, head of Prudential's global equity transactions. See Leanard, *supra* note 57, at 19.

58. See VENTURE CAPITAL IN OECD COUNTRIES, *supra* note 31, at 31 (acknowledging the role of Nasdaq in allowing smaller companies to participate in the market).

59. See Ogden, *supra* note 11, at 54-55. "High tech companies find it especially advantageous to list in the United States." *Id.* at 54; see also Barbara

Additionally, foreign companies are often able to obtain higher valuations in the United States, gain access to financing more quickly, and encounter fewer market restrictions.⁶⁰ The active second tier market in the United States serves as a pipeline for future public offerings, thereby enhancing the liquidity of the market as a whole.⁶¹ In response to the comparative advantage presented by the favorable United States investment climate, second tier markets in Europe and Asia have recently emerged to compete for these new issues.⁶²

Access to the United States market, however, remains constrained by foreign companies' concern with certain factors, such as United States disclosure requirements, accounting standards, and legal liability.⁶³ Foreign issuers also view the cost, time, and administrative burdens involved in addressing these concerns as significant deterrents to tapping the American capital markets.⁶⁴ There may be structures and strategies available, however, to address these concerns. For foreign companies seeking access to the United States capital

Steuart, *The Growing Numbers of Overseas Companies Going Public in the United States Could Provide an Opportunity for Firms Seeking to Break Into the Lucrative High-Tech IPO Market*, THE RECORDER, Feb. 26, 1996, para. 17, available in LEXIS, News Library, Cumws File. "Foreign companies not only find that raising money in the United States is often easier than at home. More importantly, foreign high-tech ventures can raise more money here. Since United States investors are willing to bank on a company's earning potential—rather than just its past performance—U.S. capital markets are the most attractive for high-tech start-ups. See *id.*

60. See *Foreign Issuers Flying Faster Toward United States Market*, GOING PUBLIC: THE IPO REP., INVESTMENT DEALERS' DIG., Sept. 4, 1995, para. 5, available in LEXIS, News Library, IDD File.

61. Paul Taylor, *At Last, A Pipeline Opens*, FIN. TIMES, Sept. 20, 1996, at 3.

62. See discussion *supra* note 55 and accompanying text. The United States capital markets' comparative advantage against other countries' markets rests at least in part on the ability of many new, high-growth and small cap stocks to tap the market. See *id.* In response to this advantage, the markets of some of the other major developed countries, such as France, are scrambling to create their own second tier markets. See *The 'Nouveau Marche,'* FIN. REG. REP., Mar. 1996, *passim*. Recently, new second tier markets like the Nouveau Marche and Easdaq were established in Europe. See Taylor, *supra* note 61, *passim*. These markets join London's Alternative Investment Market (AIM), which has helped raise capital for more than 130 technology companies since its inception. See *id.* para. 25.

63. See Michael A. Schneider, *Foreign Listings and the Preeminence of U.S. Securities Exchanges: Should the SEC Recognize Foreign Accounting Standards?*, 3 MINN. J. GLOBAL TRADE 301, 315-17 (1994).

64. See *id.* at 314 (noting factors that foreign issuers classify as deterrents to accessing United States capital markets).

markets for the first time, for example, it may be possible to overcome traditional challenges by structuring the transaction as a private equity investment and utilizing American Depositary Receipts as the offering vehicle.⁶⁵ By utilizing such a structure, the foreign company enables its investors to access the liquidity of the United States market and enhance the potential for a successful exit from the investment, yet avoid the problems typically experienced by a foreign company when registering a public offering in the United States.⁶⁶ Additionally, the foreign company is able to establish an introductory presence within the United States markets, a critical component of a small or medium-sized foreign company's long-term growth prospects.⁶⁷

C. PREFERRED OFFERING VEHICLE: AMERICAN DEPOSITARY RECEIPTS

A foreign company seeking to access the United States market may make a direct offering of its stock or utilize American Depositary Receipts (ADRs).⁶⁸ For the investor, ADRs offer the advantage of avoiding problems with currency translation,⁶⁹ subjecting the investor to commissions in both the home country and the United States, subjecting the investor to tax and settlement practices in the foreign company's home country, and avoiding United States re-

65. See Saunders, *supra* note 53, at 50 (recognizing that for private foreign issuers, ADRs provide a market for securities that is cost-effective, with minimum disclosure and attendant potential liability).

66. See *id.* (discussing advantages that ADRs hold for foreign private investors).

67. See *supra* notes 57-59 and accompanying text (acknowledging the ability of small and mid-sized foreign companies to access U.S. markets as advantages).

68. See Saunders, *supra* note 53, at 62 (regarding various ways in which foreign companies may gain access to the American market); see also Kirk S. Schumacher, *Foreign Securities: Integration and Disclosure Under the Securities and Exchange Acts*, 58 NOTRE DAME L. REV. 911, 911-912 (1983) (discussing foreign securities markets in the United States). ADRs are negotiable, dollar-denominated instruments issued by a United States depository bank which verify that offsetting shares in the foreign company are held in that depository's custodian bank abroad. See THE MCGRAW-HILL HANDBOOK ON AMERICAN DEPOSITARY RECEIPTS, xv (Richard Jay Coyle ed., 1995) [hereinafter THE MCGRAW-HILL HANDBOOK].

69. See Daniel Julian Hubbard & Robert K. Larson, *American Depositary Receipts: Investment Alternative or Quicksand*, CPA J., July 1995, at 70. ADRs do not mitigate the investor's susceptibility to currency devaluation of the foreign security. See *id.* at 72.

strictions on purchasing foreign securities imposed on such institutional investors as banks and money managers.⁷⁰ The United States depository bank for ADRs assumes the responsibility for collecting, converting to United States dollars, and distributing the share dividends.⁷¹ The depository bank also provides investors with current information about the foreign issuers and votes the securities at the direction of the investors.⁷² Additionally, the United States holders may freely sell ADRs or underlying shares in the foreign market.⁷³ These advantages potentially enhance the receptivity of the United States investor to acquiring the foreign company's securities.⁷⁴

As ADRs establish an increasing presence in the United States, it is critical to note that the investor possesses the choice either of a "sponsored" or an "unsponsored" ADR.⁷⁵ A sponsored ADR program involves a contractual relationship between the foreign issuer and the United States depository bank.⁷⁶ The depository agreement between the foreign issuer and the bank establishes the rights and obligations of the parties with respect to the ADRs and the underlying securities.⁷⁷ It also effectively becomes the cornerstone to defining the relationship between these parties and the shareholders. An unsponsored ADR program involves the development of a United States market in the foreign issuer's securities, but without the contractual consent of that foreign company.⁷⁸ Both cases raise unique securities law issues that require careful consideration by the foreign company and the United States depository bank.⁷⁹

70. See THE MCGRAW-HILL HANDBOOK, *supra* note 68, at 6-9 (outlining ADR benefits).

71. See Bart J. Colli & Debra S. Grossier, *The What, Why and How of Depositary Receipts*, N.J.L.J., June 5, 1995, at 10.

72. See *id.*

73. See *id.*

74. See *id.* (describing the advantages that ADRs offer to United States investors). Additionally, research by Broadgate Consultants indicates that investors believe maintenance of an ADR facility for a foreign issuer in the United States demonstrates a commitment by that issuer to the United States investor, thereby enhancing the level of confidence in the company. See Urry, *supra* note 10, at 36.

75. See THE MCGRAW-HILL HANDBOOK, *supra* note 68, at 8 (describing the two varieties of ADR facilities).

76. See *id.* at 8.

77. See *id.* at 10.

78. See *id.* at 9. For a primer on the use of ADRs in the United States, see Saunders, *supra* note 53, *passim*.

79. See THE MCGRAW-HILL HANDBOOK, *supra* note 68, at 104-73 (describing

ADRs are used in conjunction with both United States public offerings and private placements.⁸⁰ After their introduction in 1927,⁸¹ ADRs experienced relatively infrequent use until 1990, when they emerged as the offering instrument of choice for the foreign issuer.⁸² For instance, the first nine months of 1996 saw the creation of 151 new ADR programs from 46 countries, in comparison to 105 new ADR programs from 31 countries in the first nine months of 1995.⁸³ Of those 151 programs, 74 involved initial public offerings, which raised \$7.4 billion, with the remaining \$2.9 billion raised through secondary offerings of existing ADR programs.⁸⁴ Another indicator of the growth in the use of ADR offerings is that in 1992 the Nasdaq listed 87 ADR issuers, while the New York Stock Exchange listed 82, and the American Stock Exchange listed eight.⁸⁵ By 1995, the Nasdaq presented 112 ADR offerings, the NYSE noted 166, and the American Stock Exchange listed seven.⁸⁶

III. STRUCTURING THE OFFERING UNDER THE FEDERAL SECURITIES LAWS

A United States offering of securities in a foreign company, either through a direct offering of securities or ADRs, must comply with the requirements of United States federal securities laws or be ex-

the application of American securities laws to ADRs). One advocate in favor of the creation of unsponsored ADRs stresses that they provide foreign companies with a means of limiting their potential liability under American securities laws because the foreign company does not become a "foreign private issuer," due to the fact that it does not sign Form F-6. See Ralph Marinello, *The Unsponsored Marketplace*, in THE MCGRAW-HILL HANDBOOK, *supra* note 68, at 95-96. For companies from emerging markets, in particular, the author contends that the voluntary creation of unsponsored ADRs is a low-cost means of gaining an introductory presence in the United States capital markets by allowing ADRs representing its securities to be traded on the Nasdaq over-the-counter market. See *id.*

80. See Schneider, *supra* note 63, at 314-19 (noting the role of ADRs in this context).

81. See Saunders, *supra* note 53, at 50 (noting the birth of the ADR as an investment vehicle).

82. See *id.* (observing that ADRs are the most common method invoked by foreign private issuers to raise capital in the United States market).

83. See *Wall Street's Global Equity Boom*, *supra* note 3, para. 15.

84. See *id.*

85. See NAT'L ASSOC. OF SECURITIES DEALERS, THE NASDAQ STOCK MARKET 1996 FACT BOOK & COMPANY DIRECTORY 14 (1996).

86. See *id.* at 31.

empt therefrom.⁸⁷ The Securities Act of 1933 (the "Securities Act") requires the registration of foreign securities publicly offered in the United States and the disclosure of specified information about those securities and the foreign issuing company pursuant to Forms F-1, F-2, or F-3.⁸⁸ Additionally, the Securities Exchange Act of 1934 (the "Exchange Act") requires periodic reporting of information concerning the company and securities that are trading in the United States pursuant to Form 20-F and Form 6-K, unless the foreign issuer is eligible for an exemption therefrom.⁸⁹

Form F-6 is used to register American Depositary Receipts (ADRs) representing shares in securities of a foreign company offered in the United States either publicly or pursuant to an exemption.⁹⁰ Three conditions precedent exist to utilizing Form F-6.⁹¹ First, the ADRs registered using Form F-6 must represent only securities offered or sold in transactions registered under the Securities Act or which are exempt therefrom.⁹² Second, the issuer must be already subject to the reporting requirements of the Exchange Act or exempt by Rule 12g3-2(b).⁹³ Third, the terms of the ADRs must allow holders to withdraw the securities represented at any time, subject only to temporary administrative delays.⁹⁴

87. See Robert E. Murray & J.P. Morgan, *Instruments of International Finance: The History of ADRs*, in THE MCGRAW HILL HANDBOOK, *supra* note 68, at 1, 11-17 (explaining the requirement that companies either must comply with American securities regulations or obtain the requisite exemptions). See generally Jay D. Hansen, *London Calling?: A Comparison of London and U.S. Stock Exchange Listing Requirements for Foreign Equity Security*, 6 DUKE J. COMP. & INT'L L. 197, 206 (1995) (discussing trading on American exchanges on the satisfaction of respective listing requirements). Foreign issuers seeking to make an offering in the United States must also comply with applicable state securities laws. See Howard S. Zepran, *U.S. Public Offerings and Periodic Reporting by Foreign Issuers*, PRACTICING L. INST./CORP. 741, 746 (1996). The listing requirements of United States exchanges and compliance with state securities laws are beyond the scope of this inquiry.

88. See *infra* text accompanying notes 101-11 (discussing the proper use of Forms F-1, F-2, and F-3).

89. See *infra* text accompanying notes 165-178 (referencing information required under Form 20-F and Form 6-K).

90. See 17 C.F.R. § 239.36 (1997).

91. See *id.*

92. See *id.* § 239.36(b).

93. See *id.* § 239.36(c).

94. See *id.* § 239.36(a)(1).

A. PUBLIC OFFERING UNDER THE SECURITIES ACT

The Securities Act prohibits the public offering or sale of securities in the United States “unless a registration statement has been filed as to such security.”⁹⁵ The restrictions imposed by Section 5 of the Securities Act prohibit marketing efforts in conjunction with an offering of securities prior to the filing of a registration statement with the Securities and Exchange Commission (SEC),⁹⁶ limit the use of written materials distributed in the offering period to the preliminary prospectus filed as part of the registration statement,⁹⁷ and prevent the confirmation of sales of securities until the SEC deems the registration statement effective.⁹⁸

Where the foreign issuer seeks to make a public offering in the United States, it faces rigorous disclosure requirements prior to the offering. These requirements are substantially similar to those required of United States issuers⁹⁹ and are typically significantly more stringent than those of most foreign regulators.¹⁰⁰ The standard registration forms for the securities of the “foreign private issuer”¹⁰¹ include Forms F-1, F-2, or F-3.¹⁰² Form F-1 is a long-form registration statement filed by foreign issuers prior to making a public offering in

95. Securities Act of 1933 § 5, 15 U.S.C. § 77(e) (1996) [hereinafter Securities Act].

96. *See id.* § 5(c), 15 U.S.C. § 77(e).

97. *See id.* § 5(b)(1), 15 U.S.C. § 77(e).

98. *See id.* § 5(b)(2), 15 U.S.C. § 77(e).

99. *See* Erica H. Steinberger, *Application of the U.S. Securities Laws to ADRs*, in THE MCGRAW-HILL HANDBOOK, *supra* note 68, at 104, 111 (discussing the disclosure requirements to which American issuers are subject).

100. *See* Harold Schimkat, *The SEC's Proposed Regulations of Foreign Securities Issued in the United States*, 60 FORDHAM L. REV. 203 (1992).

101. *See* 17 C.F.R. § 240.3b-4(c) (defining “foreign private issuer” as any foreign issuer other than a foreign government unless more than 50 percent of its outstanding voting securities are held by United States citizens, and a majority of the officers or directors are United States citizens or more than 50 percent of the assets are located in the United States or the issuer's business is principally conducted in the United States). Additionally, “a ‘foreign issuer’ is any issuer that is a foreign government, a national of a foreign country, or a corporation or other organization incorporated or organized under the laws of a foreign country.” *Id.* at §§ 240.3b-4(b).

102. *See* Steinberger, *supra* note 99, at 151 (comparing disclosure requirements under Forms F-1, F-2, or F-3 to similar disclosure requirements under Forms S-1, S-2, or S-3).

the United States.¹⁰³ It is intended for use by a foreign issuer that is not yet subject to the periodic reporting requirements of the Exchange Act, or alternatively, subject to the Exchange Act but not eligible to use Forms F-2 or F-3.¹⁰⁴ Forms F-2 and F-3 are both short form registration statements available for use by foreign issuers after being a United States reporting company for a period of at least 36 months.¹⁰⁵ A foreign issuer may also use Forms F-2 and F-3 if it has not been a reporting company for more than 12 months and has a worldwide market float of voting securities in excess of \$75 million.¹⁰⁶

Form F-1 requires the issuer to provide a description of the company, the nature of its business, its holdings, the existence of material legal proceedings, and a discussion of the risk factors related to the securities, the company, and the home country.¹⁰⁷ In addition, this form requires disclosure regarding the intended use of the offering proceeds, information about those shareholders in the company seeking to sell securities in the offering, and other specified financial information.¹⁰⁸

The most difficult F-1 disclosures for a foreign issuer concern the financial statements.¹⁰⁹ These disclosures must comply with Regulation S-X, which requires issuers to provide audited, consolidated balance sheets for the issuer covering the last two years, as well as audited statements of income and cash flows for each of the issuer's three most recent fiscal years.¹¹⁰ The issuer must provide the financial statements either in accordance with United States Generally Accepted Accounting Principles (GAAP) or the accounting principals of the issuer's home country, provided the issuer also supplies

103. *See id.* at 153.

104. *See* 17 C.F.R. § 239.31 (1997).

105. *See id.* § 239.32.

106. *See id.* § 239.33.

107. *See* Steinberger, *supra* note 99, at 112-15.

108. *See id.* at 113-14 (specifying information required in the prospectus).

109. *See* Todd Cohen, *The Regulation of Foreign Securities: A Proposal to Amend the Reconciliation Requirement and Increase the Strength of Domestic Markets*, 1994 ANN. SURV. AM. L. 491, 496 (1995) (stating that the reconciliation of financial statements requirement is the most frequent "cause for foreign issuers' reluctance to offer their securities in the United States."); *see also id.* at 114 (pointing to Items 11 and 16 of Form F-1).

110. *See* 17 C.F.R. § 210.3-19 (1997); *see also id.* at 129, 142-44 (citing Item 17 and item 18 of Form 20-F).

corresponding reconciliation of such statements to GAAP.¹¹¹ This latter alternative is often preferred by foreign companies due to the decreased administrative burdens and time required to make such filings.¹¹²

Additionally, Regulation S-K requires the foreign private issuer to provide financial data from the last five years of the company (or the life of the company if less than five years) relating to the issuer's net sales or operating revenues, income or losses realized, total assets, long-term obligations, redeemable preferred stock, and cash dividends per share.¹¹³ It requires the issuer to provide a "Management's Discussion and Analysis" (MD&A) about the issuer, including a discussion of the results of operations, liquidity, capital resources, and other information which will help investors understand the company's performance.¹¹⁴ Regulation S-K also requires the prospectus for the securities to include a caption on the cover page, discussing the principal factors that may make the investment speculative or subject to high risk for the investor.¹¹⁵

By making a public offering in the United States, the foreign private issuer is subject to the liability provisions of the United States securities laws, one of the most significant deterrents to making an offering in the United States.¹¹⁶ For example, Section 11 of the Securities Act imposes strict liability on any issuer making a material

111. See Integrated Disclosure System for Foreign Private Issuers, Securities Act Release No. 6360 [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,054, ¶ 84, 129, and 135-36 (Nov. 20, 1981) (citing Item 8 of Form 20-F).

112. See David S. Ruder, *Reconciling U.S. Disclosure Policy With International Accounting and Disclosure Standards*, 17 NW. J. INT'L L. & BUS. 1, 8 (1996) (requiring reconciliation only of material differences in the preparation of financial statements without requiring reconciliation to United States GAAP in certain categories).

113. See 17 C.F.R. § 229.301 (1997).

114. See *id.* § 229.303. The issuer also must provide an MD&A as part of its Exchange Act filing pursuant to Form 20-F, Item 9. See Steinberger, *supra* note 99, at 130, 136-38 (instructing foreign private issuers to use Form 20-F as a registration statement under the Exchange Act which requires the provision of an MD&A).

115. See Securities Act Regulation K, Item 503(c), 17 C.F.R. § 229.503(c).

116. See Daniel A. Braverman, *U.S. Legal Considerations Affecting Global Offerings of Shares in Foreign Companies*, 17 NW. J. INT'L L. & BUS. 30, 46 (1996) (stating that the due diligence process required under federal securities laws is "generally considered by foreign issuers to be burdensome, intrusive, time-consuming, and expensive").

misstatement or omission in the registration statement.¹¹⁷ Section 12(2) imposes liability on anyone who sells a security through a prospectus or oral communication that contains a material misstatement or omission, unless the purchaser knew of the misstatement or omission.¹¹⁸ Rule 10b-5 of the Exchange Act also imposes liability on any person who engages in fraud, makes an untrue statement, or omits to state a material fact in connection with the purchase or sale of a security.¹¹⁹

The SEC has made a concerted effort to ease the burdens of registration for foreign issuers, yet maintain the integrity of capital markets by ensuring that a company discloses sufficient information upon which investors may base their investment decisions.¹²⁰ These efforts by the SEC have included providing longer deadlines for filing annual reports, eliminating quarterly reporting, decreasing disclosure requirements, and exempting foreign issuers from certain liability provisions under the federal securities laws.¹²¹ Such SEC accommodation, in addition to the variances permitted for reporting financial information, includes providing foreign companies with the opportunity to meet with the SEC on a confidential basis prior to filing the registration statement to ensure the sufficiency of disclosures.¹²² Nonetheless, most foreign issuers seeking to make a public offering in the United States face significant burdens not likely to be associated with capital raising in their home market and, therefore, serve as a disincentive to accessing the liquid public market in the

117. See Securities Act § 11, 15 U.S.C. § 77(k) (imposing additional liability, subject to a due diligence defense, on directors, officers, underwriters, and such third party experts as auditors and legal counsel for misstatements or omissions made in the registration statement).

118. See Securities Act § 12(2), 15 U.S.C. § 77(e).

119. See Securities Act § 10(b), 15 U.S.C. § 78(j); Securities Act Rule 10b-5, 17 C.F.R. §240.10b-5.

120. See Nicholas G. Demmo, *U.S. Securities Regulation: The Need for Modification to Keep Pace with Globalization*, 17 U. PA. J. INT'L ECON. L. 691, 704 (1996) (discussing the Securities and Exchange Commission's (SEC) willingness to facilitate securities listings by foreign issuers).

121. See EDWARD GREENE ET AL., *U.S. REGULATION OF THE INTERNATIONAL SECURITIES MARKETS: A GUIDE FOR DOMESTIC & FOREIGN ISSUERS & INTERMEDIARIES* 137 (2d ed. 1993).

122. See Braverman, *supra* note 116, at 43 (finding that the SEC has reviewed registration statements even when the statement was incomplete in order to assist foreign issuers through the registration process).

United States.¹²³

B. PRIVATE PLACEMENT EXEMPTIONS UNDER THE SECURITIES ACT

A company that does not issue securities in a "public" offering may engage in a "private placement" transaction which is exempt from the federal securities laws.¹²⁴ For foreign issuers, the private placement exemptions may serve as a beneficial means of avoiding the administrative burdens, the cost, the time, and to a certain extent, the liability associated with registering a public offering under the securities laws.¹²⁵ To take advantage of the private placement exemption of the federal securities law, the issuer must structure its initial transaction, where the foreign private issuer sells to an intermediary, to comply with the requirements of Section 4(2), Regulation D, or Regulation S under the Securities Act.¹²⁶ The issuer must conduct any subsequent resale of privately placed securities in accordance with Rule 144A or Regulation S or risk triggering the registration requirements of the Securities Act.¹²⁷

A foreign company also reduces potential legal liability, a significant disincentive to a United States offering, by structuring the transaction as a private placement.¹²⁸ Section 11 of the Securities Act imposes liability only on registered offerings,¹²⁹ and liability under section 12(2) of the Securities Act also has been held to apply only to

123. See Robert C. Mills, *Evaluating ADRs: International Accounting Standards and the World of GAAP*, in THE MCGRAW HILL HANDBOOK, *supra* note 68, at 174, 181 (stating that the "unfamiliar and unacceptable" expense of detailed footnote disclosures of financial information required by SEC regulations is not one required in other major capital markets).

124. See Securities Act § 4(2), 15 U.S.C. § 77(d) (1994).

125. See GREENE ET AL., *supra* note 121, at 137 (listing reasons why foreign issuers are reluctant to finance through the United States public market).

126. See Alan H. Paley et al., *Private Placements and Rule 144A Offerings – Recent Developments and Current Issues*, 867 PRACTICING L. INST. 667, 672 (1994) (discussing Section 4(2), Regulation D, and Regulation S exemptions from 1933 Securities Act registration provisions).

127. See GREENE ET AL., *supra* note 121, at 140.

128. See Eric M. Sherbert, *Bridging the GAAP: Accounting Standards for Foreign SEC Registrants*, 29 INT'L L. 875, 879 (1995) (stating that foreign firms may prefer private placements to avoid registration costs, including the increased liability arising from misstatements or omissions in private placement documents).

129. See Securities Act § 11, 15 U.S.C. § 77(k) (1994).

registered offerings.¹³⁰ Only Section 10(b)¹³¹ and Rule 10b-5,¹³² therefore, assert liability for material misstatements or failure to state a material fact made as part of the private placement offering.¹³³ Since Rule 10b-5 requires a showing of "scienter,"¹³⁴ the threshold for liability is relatively high in that inadvertent or negligent misstatements or omissions will not trigger liability against the foreign issuer.

1. *Initial Sale of Privately-Placed Securities*

A traditional private placement pursuant to Section 4(2) exempts from the Securities Act a transaction not involving a public offering.¹³⁵ Given Section 4(2)'s lack of definitiveness¹³⁶ and judicial interpretations¹³⁷ of what constitutes a private placement exemption from the registration and liability provisions of the Securities Act, foreign issuers have been especially reluctant to rely on the provisions of Section 4(2).¹³⁸ The SEC adopted Regulation D to provided

130. See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 584 (1995) (holding that the term "prospectus" does not include the offering documents used in a private placement, and therefore, Section 12(2) liability does not attach to the private placement).

131. See Securities Act § 10(b), 15 U.S.C. § 78 (1994).

132. See Securities Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (1997).

133. See generally, Stephen J. Choi, *Company Registration: Toward A Status-Based Anti-Fraud Regime*, 64 U. CHI. L. REV. 567, 572 (1997) (discussing Rule 10b-5 as the only liability applied to private placements).

134. See Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (stating that a violation of Rule 10b-5 requires the person acting to employ any device, scheme, or artifice to defraud). See generally *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (stating that to violate §10(b) of the Securities and Exchange Act and Rule 10b-5, scienter must be proven by showing intent to deceive, manipulate, or defraud).

135. See Securities Act § 4(2), 15 U.S.C. § 77(d) (1994) (exempting from registration transactions by an issuer not involving a public offering).

136. See Securities Act § 4(2), 15 U.S.C. § 77(d) (providing that the registration requirement of § 5 of the Securities Act does not apply to "transactions not involving any public offering.").

137. See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953) (holding that the registration provisions of the Securities Act turn on whether "the particular class of persons affected needs the protections of the Act"). "An offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering." *Id.* Whether a prospective purchaser is able to "fend for themselves" rests at least partially on the availability of information which would otherwise be included in a registration statement.

138. See generally Dr. Bishwambhar Pyakuryal & Dr. Kishar Uprety, *NEPAL*:

a limited safe harbor for the offer and sale of securities in a private offering by an issuer provided certain criteria are met.¹³⁹ These criteria include: (i) that the company does not conduct its securities offering by general solicitation or by advertisement;¹⁴⁰ (ii) that the sale involves an unlimited number of "accredited" investors and no more than 35 unaccredited investors;¹⁴¹ (iii) that the unaccredited investors receive material information similar to that provided in a public offering;¹⁴² and (iv) that the issuer ensures that the purchasers recognize the securities are restricted as to their resale.¹⁴³ In addition to Regulation D, the issuer may be able to structure the initial transaction under Regulation S,¹⁴⁴ which the SEC adopted in 1990 as a means of limiting the extraterritorial reach of the Securities Act and as a safe harbor to registration under the Securities Act.¹⁴⁵

The Emerging Security Market, 9 TRANSNAT'L L. 421, 451 (1996) (noting the clear status foreign issuers ascribe to private placements under United States federal securities laws).

139. See *Securities Indus. Ass'n v. Bankers Trust*, 807 F.2d 1052, 1064 (1986) (stating that Regulation D constitutes a "safe harbor" for non-public offerings that comply with its terms).

140. See Securities Act Rule 502(c), 17 C.F.R. § 230.502.

141. See Securities Act Rule 506(b)(2), 17 C.F.R. § 230.506. An "accredited" investor is defined to include most institutions, certain management officers and wealthy individuals. The Securities Act Rule 501(a), 17 C.F.R. 230.501. If the prospective investor is not "accredited," the issuer must reasonably believe that each purchaser has the ability or acumen to evaluate the risks associated with the investment or is represented by someone who does. Securities Act Rule 501(h), 17 C.F.R. § 230.501.

142. See Securities Act Rule 502(b)(2)(c), 17 C.F.R. § 230.502.

143. See Securities Act Rule 502(d), 17 C.F.R. § 230.502.

144. See Securities Act Rule 903, 17 C.F.R. § 230.903.

145. See James R. Doty, *Financial Institutions and Regulations: Transnational Financial Services in the 1990s*, 60 FORDHAM L. REV. S77, S90 (1992) (stating that the commission sought to clarify the extraterritorial application of the Securities Acts in adopting Regulation S). See generally Securities Act Rule 903, 17 C.F.R. § 230.903 (limiting reach of securities laws where the offer or sale of securities occurs outside the United States under Rule 901 and meets the conditions of Rule 903). In addition to establishing a safe harbor for the resale of privately-placed securities, Regulation S provides a safe harbor for offers and sales of securities by issuers and others in the distribution if the securities are sold in an off-shore transaction and there are no "directed selling efforts" in the United States by the issuer or any distributor. Securities Act Rule 903, 17 C.F.R. § 230.903. While this specific safe harbor offered by Regulation S may represent an option for the foreign company seeking to sell its equities, since the focus of this inquiry is on addressing means of directly tapping the United States capital markets as an exit to the international private equity investment, the issue is not extensively discussed

2. *Resale of Restricted Securities of Foreign Issuer*

Securities sold pursuant to a private placement exemption are "restricted" as to the purchaser's ability to resell those securities and, therefore, are not subject to immediate resale in the public secondary market.¹⁴⁶ On February 28, 1997, the SEC amended Rule 144 to reduce the holding period to one year for securities acquired pursuant to a private placement transaction prior to resale by any person if sold in limited quantities.¹⁴⁷ Any non-affiliate of the issuer may sell an unlimited quantity of the privately placed securities after two years.¹⁴⁸ It is anticipated that these shorter holding periods will improve the liquidity of the privately placed securities, particularly for small and medium-sized companies.¹⁴⁹

The SEC adopted Rule 144A and Regulation S under the Securities Act to remove the ambiguities of the United States private placement scheme.¹⁵⁰ Both are designed to facilitate the resale of restricted, privately placed securities and thereby add liquidity to the market for these securities.¹⁵¹ Rule 144A is intended to enhance the

here.

146. See GREENE ET AL., *supra* note 121, at 139-40.

147. See Revision of Holding Period Requirements in Rules 144 and 145, Securities Act Release No. 33-7390, 62 Fed. Reg. 9,242 (1997) (to be codified at 17 C.F.R. pt. 144).

148. See *id.* Prior to amendment, purchasers of restricted securities could resell limited quantities of such securities in two years and unlimited quantities in three years. See *id.*

149. See SEC *Restrictions on Insider Sales Undergoing Overhaul*, VENTURE CAPITAL J., April 1997, at 9-10 (noting that "[n]ot only will the change in the ruling allow investors to realize gains sooner, it should also encourage more private placements in small companies."). The author further highlights the comments of a private placement manager who opined: "Anything to shorten the [exit] window is obviously a good move for us; we're looking forward to more such revisions [to investment rules]." *Id.*

150. See generally Doty, *supra* note 145, at S90 (stating that both Rule 144A and Regulation S were adopted to adapt to the global securities markets and encourage private placements as a capital-raising option). The Rule 144A safe harbor is available to both foreign and domestic privately-placed securities. A primary rationale for adopting Rule 144A, however, was to facilitate the liquidity of foreign shares trading in United States. See *id.*

151. See Lisa K. Bostwick, *The SEC Response to Internationalization and Institutionalization: Rule 144A Merit Regulation of Investors*, 27 L. & POL'Y INT'L BUS. 423, 431 (1996) (stating that the intent of Rule 144A was to increase liquidity in the private placement market); Todd Cohen, *The Regulation of Foreign Securities: A Proposal to Amend the Reconciliation Requirement and Increase the*

liquidity of the entire private placement process, even though it relates specifically only to the resale of restricted securities.¹⁵² By clarifying the procedures available for conducting both the initial and resale transactions, it enhances the marketability of the securities.¹⁵³ Rule 144A is also intended to enhance the attractiveness of the United States market for foreign issuers by eliminating the barriers which forced United States investors to purchase foreign securities overseas rather than through United States intermediaries.¹⁵⁴

Rule 144A allows the resale of privately placed securities to "qualified institutional buyers" without requiring that the securities be registered under the Securities Act.¹⁵⁵ To take advantage of the non-exclusive safe harbor of Rule 144A, the issuer must meet the following conditions: (i) the issuer may only offer or sell the securities to a "qualified institutional buyer;" (ii) the seller must take "reasonable steps" to ensure that the buyer is aware that the seller is relying on the Rule 144A safe harbor; (iii) the securities are not part of the same class which is traded on a United States exchange or Nasdaq (i.e., the securities are not "fungible");¹⁵⁶ and (iv) the issuer either is a reporting company under the Exchange Act or is exempt therefrom by maintaining an exemption under Rule 12g3-2(b) and provides reasonably current information to the purchaser.¹⁵⁷

Building on the premise of the Section 4(2) private placement exemption that the purchaser of such exempt securities has the ability to "fend for themselves," Rule 144A defines a class of persons constituting "qualified institutional buyers" (QIBs) to provide certainty as to who may be a purchaser.¹⁵⁸ QIBs include institutions which own or invest on a discretionary basis \$100 million of securities, and

Strength of Domestic Markets, 1994 ANN. SURV. AM. LAW 491, 549 (1995) (noting how Regulation S has facilitated global offerings by adding clarity to the United States securities laws).

152. See Cohen, *supra* note 151, at 549 (mentioning the clarity that Regulation S provides and the fact that this should facilitate global offerings).

153. See Bostwick, *supra* note 151, at 431 (describing the intent of Rule 144A to provide more efficiency and liquidity in the private placement market).

154. See GREENE ET AL., *supra* note 121, at 141-42.

155. See Securities Act Rule 144A(b), 17 C.F.R. § 230.144A(b) (1997).

156. This does not include the "pink sheets" market of the National Quotations Bureau.

157. See Securities Act Rule 144A(d), 17 C.F.R. § 230.144A(d) (1997).

158. See Securities Act Rule 144A(a)(1), 17 C.F.R. § 230.144A(a)(1) (1997) (defining qualified institutional buyer).

are either: (i) an insurance company; (ii) an investment company; (iii) an investment advisor; (iv) a corporation, partnership, or business trust; (v) any employee benefit plan sponsored by a governmental entity; (vi) any employee benefit plan pursuant to ERISA; (vii) any non-profit organization; (viii) any small business investment company (SBIC); (ix) any broker or dealer that owns or invests more than \$10 million; (x) any United States or foreign bank or thrift with an audited net worth of at least \$25 million; or (xi) any other organization all of whose beneficial owners are QIBs.¹⁵⁹ For the foreign company seeking additional financing, it is wise to note that these entities typically are the same types of institutions which dominate the private equity market and, therefore, constitute an attractive set of offerees.¹⁶⁰

Regulation S provides a safe harbor for the resale of privately-placed securities (including those acquired in the United States pursuant to a Rule 144A transaction exempt from registration) by investors as long as two conditions are met: (i) the seller may not use directed selling efforts; and (ii) the sale must be made in an "off-shore transaction."¹⁶¹ An offshore transaction is one in which the offer is not made in the United States, and the order to buy is not made, or is reasonably believed by the seller not to have been made, in the United States.¹⁶² Once resold outside the United States, these privately placed securities are not restricted and may be sold anywhere, including the United States.¹⁶³ By virtue of their amenability to immediate sale outside the United States, the liquidity of restricted, privately-placed securities of a foreign company is significantly enhanced.¹⁶⁴

159. See Securities Act Rule 144A(a)(1), 17 C.F.R. § 230.144A(a)(1) (1997).

160. See also *supra* note 22 and accompanying text.

161. See Securities Act Rule 904, 17 C.F.R. § 230.904 (1997).

162. See Securities Act Rule 902i, 17 C.F.R. § 230.902i (1997).

163. See *In the Matter of GFL Ultra Fund Ltd.*, Administrative Proceedings Release No. 3-9333 (June 18, 1997), available at 1997 WL 330419, at 3 (noting procedural safeguards present under Regulation S whereby the issuer may offer or sell the shares in the United States following the 40 day restricted period for reporting issuers).

164. See GREENE ET AL., *supra* note 121, at 167.

C. APPLICABILITY OF THE EXCHANGE ACT

A foreign private issuer is subject to the periodic reporting requirements of the Exchange Act¹⁶⁵ if it has made a public offering of securities in the United States or has registered a class of securities under the Exchange Act.¹⁶⁶ A foreign issuer must register a class of securities under the Exchange Act if it lists those securities on an United States exchange or Nasdaq¹⁶⁷ or that class of securities is held by more than 500 shareholders—300 of whom are United States residents—and the issuer has more than \$5 million in assets.¹⁶⁸

A foreign private issuer meeting these criteria must register under the Exchange Act and file an annual report pursuant to Form 20-F, as well as periodic reports pursuant to Form 6-K.¹⁶⁹ Of particular note, Form 20-F requires the foreign private issuer to provide audited financial statements reconciled with United States GAAP, similar to the filings made with Form F-1 under the Securities Act.¹⁷⁰ Form 6-K requires filing information that the issuer makes public in its home country, files with an exchange where its securities are listed, or distributes to its shareholders.¹⁷¹

Pursuant to its authority in Section 12(g)(3) of the Exchange Act,¹⁷² the SEC has adopted exemptions to the Exchange Act requirement of registration and periodic reporting for certain foreign issuers.¹⁷³ First, Rule 12g3-2(a) provides that a foreign issuer with fewer than 300 United States resident shareholders in any class of its securities is not required to register those securities, or the ADRs

165. See Exchange Act § 13, 15 U.S.C. § 78(m) (1994) (setting forth the reporting requirements of the Securities Exchange Act of 1934).

166. See Exchange Act § 15(d), 15 U.S.C. § 780.

167. See Exchange Act § 12(b), 15 U.S.C. § 78l.

168. See Exchange Act Rule 12g3-2(a), 17 C.F.R. § 240.12g3-2(a).

169. See Exchange Act Form 6-K (requiring foreign private issuers to furnish reports pursuant to Rule 13a-16 or 15d-16 under the Securities Exchange Act of 1934).

170. See Exchange Act Form 20-F, Part IV.

171. See Exchange Act Form 6-K, General Instruction B. This information closely replicates the information the foreign private issuer must furnish pursuant to the Rule 12g3-2(b) exemptions. See 17 C.F.R. § 240.12g3-2(b) (1997).

172. See Exchange Act § 12(g)(3), 15 U.S.C. § 78i (empowering the SEC to make rules to exempt any foreign issuer's securities from subsection 12(g)).

173. See Exchange Act Rule 12g3-2, 17 C.F.R. § 240.12g3-2 (1997).

which may represent underlying securities.¹⁷⁴ Second, Rule 12g3-2(b) provides that if a foreign issuer has more than 300 United States shareholders in a class of its equity securities, it is exempt from Exchange Act registration and reporting if it agrees to “furnish” the SEC with home country information.¹⁷⁵

Known as the “information-supplying exemption,” Rule 12g3-2(b) requires the issuer to provide information it is required to make public in its home country, file with an exchange where those securities are listed, or which the issuer otherwise distributes to its shareholders.¹⁷⁶ The foreign issuer must furnish this information to the SEC along with a list identifying the information and all recipients.¹⁷⁷ Since this information is “furnished” to, rather than “filed” with the SEC, the issuer is not subject to the liability imposed by Section 18 of the Exchange Act,¹⁷⁸ and this Section triggers no further reporting requirements.

IV. MARKET TIERS FOR THE ADR OFFERING

A foreign company seeking to offer its securities in the United States either may list its securities or ADRs on an United States exchange or Nasdaq,¹⁷⁹ have its securities traded in the over-the-counter or “pink sheet” market,¹⁸⁰ or make a private placement.¹⁸¹ If the foreign company utilizes ADRs to make its offering, it must structure its offering to avail itself of one of the various levels of ADR facilities.¹⁸² These levels are tiered to permit those companies which meet the full disclosure requirements of the securities laws access to the highly liquid public markets.¹⁸³ Those companies which seek an exemption from the United States securities laws, and therefore do not

174. See Exchange Act Rule 12g3-2(a), 17 C.F.R. § 240.12g3-2(a) (1997).

175. See Exchange Act Rule 12g3-2(b), 17 C.F.R. § 240.12g3-2(b) (1997).

176. See Exchange Act Rule 12g3-2(b)(1)(i), 17 C.F.R. § 240.12g3-2(b)(1)(i) (1997).

177. See Exchange Act Rule 12g3-29(b)(1)(ii), 17 C.F.R. § 240.12g3-2(b)(1)(ii) (1997).

178. See Exchange Act § 18, 15 U.S.C. § 78(r) (imposing liability for false or misleading statements filed with the SEC).

179. See THE MCGRAW-HILL HANDBOOK, *supra* note 68, at 72-73.

180. See *id.* at 72.

181. See *id.* at 73-74.

182. See *id.* at 70-71.

183. See *id.* at 72-73.

meet United States disclosure standards, are limited to accessing the less liquid over-the-counter markets through a Level I ADR program or the private placement market.¹⁸⁴

A Level III ADR program involves making a public offering, which is listed on an exchange or Nasdaq, as part of the foreign issuer's capital raising activities.¹⁸⁵ Consequently, the foreign issuer must file a Form F-1 concerning the securities and the issuer, a Form F-6 concerning the ADRs and the depositary agreement, and a Form 20-F under the Exchange Act.¹⁸⁶

An American exchange or the Nasdaq market quote Level II ADR programs that have not been part of the capital raising activities of a registered public offering.¹⁸⁷ The foreign issuer is required to file a Form F-6 under the Securities Act and a Form 20-F under the Exchange Act, as the Rule 12g3-2(b) exemption is not available.¹⁸⁸ As such, the issuer is subject to the disclosure and accounting requirements of the federal securities laws for foreign private issuers.¹⁸⁹

A Level I ADR facility allows a foreign company to trade its ADRs in the over-the-counter (OTC) or "pink sheet" market.¹⁹⁰ By utilizing the over-the-counter market, the foreign company can avoid the full registration and reporting requirements of the federal securities laws if: (i) the issue has less than 500 total shareholders, or the foreign company has less than \$10 million in total assets;¹⁹¹ (ii) the issue has less than 300 shareholders who are residents of the United States;¹⁹² or (iii) the issue involves an issuer not qualified for an exemption either under one of the first two exemptions but which is eligible for a Rule 12g3-2(b) exemption, the "information-supplying exemption" available to certain foreign companies.¹⁹³

To establish a sponsored Level I ADR program, the depositary and

184. See THE MCGRAW-HILL HANDBOOK, *supra* note 68, at 75.

185. See *id.* at 72.

186. See *id.* at 83.

187. See *id.* at 82.

188. See *id.*

189. See THE MCGRAW-HILL HANDBOOK, *supra* note 68, at 82.

190. See *id.* at 72.

191. See Exchange Act Rule 12g-1, 17 C.F.R. § 240.12g-1 (1997).

192. See Exchange Act Rule 12g3-2(a), 17 C.F.R. § 240.12g3-2; see also *supra* text accompanying notes 171-77.

193. See Exchange Act Rule 12g3-2(b), 17 C.F.R. § 240.12g3-2(b)(1997); see also *supra* text accompanying note 175.

the foreign issuer must file a Form F-6 for ADRs with the SEC.¹⁹⁴ If the Level I ADR program is unsponsored, the depositary generally assumes the responsibility of filing the Form F-6 and requests that the issuer file and maintain a Rule 12g3-2(b) exemption.¹⁹⁵ As long as the issuer does not use the Level I ADR program to raise capital, and the Rule 12g3-2(b) program is maintained, it is not necessary for the foreign private issuer to file a Form F-1, F-2, or F-3.¹⁹⁶ Therefore, the foreign issuer is able to avoid providing the extensive disclosures required under the federal securities laws.¹⁹⁷ Additionally, as a non-reporting company under the securities laws, but one that trades in the over-the-counter market, the foreign company is not required to report or reconcile its financial statements in accordance with United States GAAP.¹⁹⁸ Rather, the foreign company is only required to provide financial information in accordance with its home country standards.¹⁹⁹

V. THE OUTLOOK FOR INTERNATIONAL PRIVATE EQUITY INVESTING

As foreign equity activity in the United States increases, market conditions for international private equity investing are improving.²⁰⁰ First, the United States public markets are becoming more receptive to offerings from smaller companies, including companies from emerging markets.²⁰¹ For example, in 1995, the most significant foreign equity activity in the United States related to large state privatizations.²⁰² By 1996, the next tier of smaller companies began in ear-

194. See THE MCGRAW-HILL HANDBOOK, *supra* note 68, at 75.

195. See *id.* at 71-72. Since the issuer does not sign Form F-6 in an unsponsored ADR program, its liability under federal securities laws is minimized. See *supra* note 178 and accompanying text discussing liability.

196. See Schimkat, *supra* note 100.

197. See *id.* at S209.

198. See *id.*

199. See Schneider, *supra* note 63, at 321.

200. See Urry, *supra* note 10, at 33.

201. See *id.*

202. See *id.* According to statistics from Citicorp, 42 percent of all ADR offerings in 1995 were attributable to large state privatizations, including ENI, the large Italian oil and gas group, and Telefonica de Espana, the Spanish telecom company. See *id.* The United States offering of Deutsche Telekom also was in the 1995 pipeline and proved highly successful in 1996. See *id.*

nest to seek access to the United States market. Many United States registrations of foreign companies were for less than \$100 million and included offerings from Argentina, Europe, Israel,²⁰³ Mexico, and Taiwan, among other countries.²⁰⁴

Second, many countries are actively encouraging the development of environments in their home markets conducive to private equity and venture capital investing.²⁰⁵ In Asia, Europe, Latin America, and Russia, governments and the private sector have worked actively to foster entrepreneurial activity by restructuring the regulatory environment, establishing financial incentives for new company development, creating secondary markets more conducive to the listing of small and medium-sized companies, and introducing new financing techniques into the home country markets.²⁰⁶

Third, many of the leading private equity investors, including emerging market funds and venture capital companies, are dedicating time, capital, and other resources to investing abroad.²⁰⁷ In 1992, more than 550 United States venture capital firms did business on an international basis.²⁰⁸ Recently, the private equity and venture capital arms of major United States financial institutions have made a concerted effort to enhance their presence in foreign countries.²⁰⁹ Fur-

203. See Taylor, *supra* note 61, at 3. Offerings by companies from Israel, particularly small, high-growth ventures, have experienced success in United States securities markets. See *id.* In fact, about 75 high-tech Israeli companies have listed on Nasdaq, many of whom previously received venture capital. See *id.*

204. See *Foreign Issuers Stream to United States IPO Market*, GOING PUBLIC: THE IPO REPORTER, INVESTMENT DEALERS' DIG., Mar. 25, 1996, at 31-32. The United States capital markets, for example, saw initial public offerings for \$28.4 million involving Elamex S.A. de C.V., a Mexican contract manufacturer, \$88 million for Disco, S.A. an Argentinean food retailer, and a \$184 million deal for Macronix International, a Taiwanese manufacturer of non-volatile memory integrated circuits. See *id.*

205. See W. Keith Schilit, *The Globalization of Venture Capital*, BUS. HORIZONS, Jan. 1992, at 17.

206. See *id.*

207. See Van Anthony et al., U.S. Dep't of Commerce, *Securities Industry: Industry Overview*, in U.S. INDUSTRIAL OUTLOOK (1994), available at WL 1363678.

208. See *id.*

209. See David G. Barry, *BancBoston Expands Into Latin America*, BOSTON BUS. J., May 31, 1996, at 10 (reporting that BancBoston Capital Inc. announced in May of 1996 that it would begin actively seeking late-stage private equity investments in Latin America). BancBoston stated that it would seek to make \$3 to \$10 million investments in companies in manufacturing, distribution, media and tele-

thermore, and perhaps of greatest significance in terms of capital dedicated to foreign markets, the IFC indicates that emerging market funds, which were virtually non-existent in 1984, had more than \$100 billion under management by about 1,000 different funds in 1994.²¹⁰

Fourth, a handful of companies from foreign countries which obtained private equity capital during their developmental years have begun to tap the United States public markets for additional financing. This development, still in its infancy, would indicate the viability of assessing United States public markets and presumably United States private equity markets, by such foreign companies. A prime example of an emerging market company that had received venture capital investment during its formative stages and later sought financing in the United States public market is Euronet, an independent, non-bank-owned ATM network founded and headquartered in Hungary in 1994.²¹¹ Euronet successfully listed its shares on Nasdaq in March 1997 for the purpose of expanding its operations throughout Central Europe.²¹² During its start-up phase, Euronet received private equity financing from Euroventures, a significant venture capital concern in Europe; Poland Partners, L.P.; Advent Partners, L.P.; Advent Private Equity Fund; Poland Investment Fund, L.P.; Hungarian Private Equity Fund; as well as other corporations and private individuals.²¹³

Alternatively, Zindart Limited, an established Hong Kong-based toy manufacturer with significant production facilities in China,

communications. *See id.* BancBoston intends to focus its exit strategies on taking these late-stage companies public in the United States on local exchanges or through an ADR listing. *See id.* In late 1995, BancBoston already had established its private equity investment presence in Asia. *See id.* This parallels similar moves by Bank of America, Citicorp, and Chase Manhattan, all of which increased their focus on international private equity investment in 1995. *See id.* Goldman Sachs also extended its private equity investment interests in India in 1995. *See* Jeremy Clift, *Goldman Sachs Says Plans Major Investment in India*, THE REUTERS EUR. BUS. REP., Nov. 28, 1995, available in LEXIS, News Library, Curnews File (noting that Goldman Sachs directs its investments towards "companies that have the prospect of real growth.").

210. *See* INVESTMENT FUNDS IN EMERGING MARKETS, *supra* note 32, at 2.

211. *See* Euronet Services Inc., Form S-1, filed with the SEC on Dec. 18, 1996 (containing Euronet's responsive, long-form statement required of all United States issuers).

212. *See id.* at 43.

213. *See id.*

which also is dependent on United States retailers as its primary customers, registered its prospectus on March 4, 1997 for an ADR offering on Nasdaq.²¹⁴ Zindart, a foreign, private issuer,²¹⁵ received significant financing in 1993 from two United States-based private equity firms: ChinaVest Group, which holds 51.5 percent of outstanding shares, and Advent International, which holds 14.9 percent.²¹⁶ Additional examples exist of foreign companies receiving private equity investments during their formative years and later accessing the United States public markets, typically through a listing on the Nasdaq National Market. However, the majority of these companies hail from other developed countries.²¹⁷

214. See Zindart Indus. Co. Ltd., Form F-1, filed with the SEC on Dec. 16, 1996, at 1.

215. See *id.* (registering the entity as a foreign private issuer able to do business in American securities markets).

216. See Zindart Indus. Co. Ltd., *Prospectus*, filed with the SEC on Mar. 4, 1997, at 5.

217. See Saville Systems P.L.C., *Prospectus*, filed with the SEC on Jan. 31, 1997 (documenting that Saville Systems is an Irish company founded in 1993 which creates customized billing solutions for telecommunications providers). Saville received significant venture capital financing prior to its listing of ADRs on Nasdaq from such concerns as Technology Crossover Ventures, L.P., Woodland Venture Fund, Seneca Ventures, several foundations, and other individuals. See *id.* Many of these investors sold at least part of their holdings in the 1996 United States offering. See *id.* It should be noted, however, that Saville, although founded and with significant operations in Ireland, ultimately filed its offering with the SEC as a United States issuer. See *id.* See also Nicholas Denton, *Rich Rewards for Esprit Backers*, FIN. TIMES, Feb. 4, 1997, at 24 (noting that Esprit Telecom, a long-distance telephone service provider based in the United Kingdom, made an offering of its securities in February of 1997 on both Nasdaq (via ADRs) and Easdaq, the new secondary market in Europe). Esprit was born in 1991 and received the venture capital backing of Apax Partners, Hancock Venture Partners, and EM Warburg Pincus during its formative years. See *id.* The investors' interests increased in value a reported five-fold from the company's listing. See *id.* See also, Firefox Communications Inc., *Prospectus*, filed with the SEC on May 5, 1995, at 43 (illustrating that Firefox Communications Inc., founded in the U.K. in 1989 but incorporated in Delaware in 1995, registered to make a public offering as a United States reporting company in 1995). Prior to the public offering, Firefox had received private equity from CIN Venture Nominees Ltd., Barclays Venture Nominees Ltd, and Railway Pension Venture Capital Ltd. See *id.*; *European Backers Bring Bio[ti]a to U.S. Market*, GOING PUBLIC: THE IPO REP., INVESTMENT DEALERS' DIG., Feb. 17, 1997. Biota AB, a Swedish medical products firm, made a public offering in the United States on February 3, 1997. *Id.* The company, which makes products to treat periodontal disease and for use with oral surgery, had the backing of three regional affiliates of a venture capital firm, Euroventures Network. See *id.*

While gaining a listing in the United States public markets is a preferred exit for the international private equity investor, it is the most difficult exit to obtain.²¹⁸ The extensive disclosure requirements for securities and the issuer under Form F-1,²¹⁹ the requirement that the company's financial statements are prepared in accordance with United States GAAP or reconciled thereto,²²⁰ and the practicalities of ensuring that a United States public offering is successful all serve as a barrier to the public offering.

In the alternative, it may be much more feasible for foreign companies, particularly small and medium-sized companies or those from emerging markets, to "test the waters" for their securities in the United States by availing themselves of an exemption from the federal securities laws and through a listing on Nasdaq's over-the-counter market (the "pink sheets")²²¹ or by conducting a private placement with institutional investors.

Ensuring that a foreign company is not subject to federal securities laws is a necessary precursor to both seeking a listing in the over-the-counter market or conducting a private placement.²²² As the initial step in designing this exit strategy, the foreign company should ascertain its status under Rule 12g3-2(a) or Rule 12g3-2(b), the so-called "information supplying exemption" under the federal securities laws.²²³ The SEC currently lists more than 1,100 foreign companies as foreign issuers exempt from the federal securities laws by Rule 12g3-2(b).²²⁴

218. See THE MCGRAW-HILL HANDBOOK, *supra* note 68, at 153-55 (listing the extensive disclosure requirements for Forms F-1, F-2, and F-3, one of which is required to gain listing on a United States market).

219. See *id.* at 153-55. As an alternative to filing as a foreign private issuer pursuant to Form F-1, some foreign companies prefer to establish themselves as United States issuers and register their securities pursuant to Form S-1. *Id.*

220. See THE MCGRAW-HILL HANDBOOK, *supra* note 68, at 158-59.

221. See *id.* at 72 (discussing exemptions).

222. See *infra* note 223. Since foreign companies, which avail themselves of an exemption from the federal securities laws, are not required to file publicly available information with the SEC, it is difficult to find case-specific examples to illustrate this approach to accessing United States markets.

223. See *supra* notes 170-77 and accompanying text.

224. See *List of Foreign Issuers Which Have Submitted Information Required by the Exemption Relating to Certain Foreign Securities*, Release No. 34-38235, International Series Release No. 1048, SECURITIES AND EXCHANGE COMMISSION, Feb. 4, 1997.

By establishing a Level I ADR program, a foreign company's ADRs may enter the United States over-the-counter market, known as the "pink sheets."²²⁵ This alternative, particularly for emerging market companies, has seen significant growth in the last several years.²²⁶ For example, a number of Russian companies made their first foray into the United States market in 1996, and their ADRs now represent about one percent of the \$2.5 billion depositary receipt market.²²⁷ Leading Russian companies that have selected this route include LUKoil, Seversky Tube Works, Torgovy Dom GUM, Tatneft, INKOMBANK, and Chernogorneft with others currently seeking to establish such programs.²²⁸ For the first time in 1994, Chinese companies also instituted United States ADR programs, including over-the-counter programs by Shanghai Erfangji and Shanghai Tire and Rubber.²²⁹ Other targets for increased ADR include Asia and

225. See *id.*; see also *supra* notes 156 and 218 and accompanying text.

226. See Stephen Davis, *The Allure of ADRs*, INSTITUTIONAL INVESTOR, Sept. 1994 ("Plainly, for non-U.S. companies eager to establish themselves in the world's biggest capital market, ADRs have emerged as the passport of choice. They offer a means of boosting a company's United States shareholder base—and hopefully, as a result of diversification, its underlying stock price as well. Once in place, an ADR program also offers a stepping-stone to future United States financing activities, from the raising of new equity to the funding of United States acquisitions.").

227. See *Wall Street's Global Equity Boom*, *supra* note 3 (stating many anticipate that Russian securities will come to represent five percent of the depositary receipt market within two years).

228. See *The Challenges of Raising Capital for Russian Companies Through ADRs*, EAST/WEST EXECUTIVE GUIDE, Oct. 1, 1996 (stating that many Russian companies will be unlikely to tap the United States public markets in the near future because of a reluctance to adopt Western accounting principals for fear of domestic tax liability). VypelCom, a start-up Russian cellular telephone company has, however, applied as a foreign private issuer (via Form F-1 filed April 23, 1997) to make a Level III ADR offering through a listing on the New York Stock Exchange. It is the first Russian company to seek to do so. VypelCom is 48 percent owned by FGI Wireless, an American company whose only activity is related to VypelCom. LUKoil, the large Russian oil and gas concern currently with a Level I ADR program has been seeking to upgrade to a Level III ADR program once its financial statements meet or are reconciled with United States GAAP. See Ben Hooson, *Beeline's Stock Issue a First for Russia*, MOSCOW TIMES, Oct. 5, 1996.

229. See *ADR Market Continues to Grow with \$12 billion raised in 1993; United States Demand for Foreign Holdings Spurs Issuance*, INVESTMENT DEALERS' DIG., Feb. 14, 1994. Also in 1994, Shanghai Petrochemical established a Level III ADR program on the NYSE and Maanshan Iron and Steel raised capital

Latin America.²³⁰ Level I ADR programs on the over-the-counter market, however, are less liquid than public markets, and without sufficient efforts to cultivate investors and gain visibility, a company's ADRs risk insufficient trading activity.²³¹

Alternatively, a Rule 144A private placement permits a company to raise capital in the United States market without being subject to the federal securities laws disclosure and accounting requirements.²³² Foreign issuers have, as intended by its adoption, used Rule 144A significantly to access the United States market.²³³ In the three years following its adoption, \$25.631 billion of securities relating to 300 foreign issuers from 43 countries²³⁴ were sold in 330 private placements.²³⁵ Of the 300 foreign issuers using the Rule 144A private placement exemption, only 17 previously enjoyed reporting company status under the federal securities laws.²³⁶ Of the remaining 283 non-reporting foreign companies, 29 subsequently became reporting companies following Rule 144A private placements in the United States capital markets.²³⁷ In the first six months of 1996, Rule 144A

in a Rule 144A private placement.

230. See *Wall Street's Global Equity Boom*, *supra* note 3 (noting that "[a]part from weak economic fundamentals, American investors remain relatively uninterested in Rule 144A offerings from Latin America, unless the growth prospects of the company are extraordinary. While investors will snap up 144A deals from European issuers in developed markets, they will look for far bigger incentives to take up a 144A deal from an issuer whose home market is very liquid.").

231. See *id.*

232. See *supra* notes 148-164 and accompanying text.

233. See *supra* note 150 (noting that "a primary rationale for adopting Rule 144A . . . was to facilitate the liquidity of foreign shares").

234. See SECURITIES AND EXCHANGE COMMISSION, STAFF REPORT ON RULE 144A, 10 (July 21, 1994) [hereinafter STAFF REPORT]. Of the 300 companies which conducted Rule 144A private placements through December 31, 1993, 96 came from Western Europe, 71 came from Asia (including Australia and New Zealand), 68 came from Latin America, 63 from North America, one from Africa and one from Eastern Europe. See *id.* at 10. The \$23,631 billion figure also includes securities from United States issuers that were guaranteed by foreign entities. See *id.* at 3.

235. See *id.* at 3. Of the \$25.631 billion in securities relating to foreign issuers and guarantors, \$6.363 billion involved common equity securities, \$707.3 million were of preferred equity securities and \$18.061 billion of debt securities. See *id.* The majority of these placements occurred in 1993. See *id.*

236. See *id.*

237. See *id.* This illustrates not only the success of Rule 144A in encouraging foreign companies to tap United States capital markets, but also the use of Rule 144A as an introductory foray into the American market which later allowed the

private placements by foreign companies alone constituted \$14.7 billion, a 99 percent increase over the first six months of 1995.²³⁸ Despite this exponentially increasing rate of growth in private placements by foreign companies, the fact that only qualified institutional buyers may trade privately placed securities among themselves causes the risk of limited liquidity if there is insufficient interest in the company.²³⁹

As the over-the-counter and private placement markets continue to introduce new foreign companies to United States investors,²⁴⁰ beginning with state privatizations and large or established companies,²⁴¹ the United States market is likely soon to see the next tier of small and medium-sized foreign companies making offerings.²⁴² As these large issuers graduate to the next wave of financing following their use of private placements or over-the-counter markets, they are likely to tap United States public markets, and newer companies will fill the void in the private market.²⁴³ Aiding these smaller companies in their search for additional financing will be adventurous emerging market funds, private equity investors, and venture capital firms ready to invest in second and third-tier companies.²⁴⁴

VI. CONCLUSION

International private equity investing, like the companies in which

reporting company to make a public offering in the United States market.

238. See Devere, *supra* note 24.

239. See Davis, *supra* note 226. Some commentators hold that for smaller foreign companies, it may be more advantageous to conduct a Rule 144A private placement than a Level I ADR offering. See *id.* For companies with less than \$100 million in market capitalization and limited mainstream appeal, the daily trading volume in ADRs is small—usually less than 10,000 shares. See *id.* Investors fear that if one major position in the ADRs were suddenly to sell, the remaining shares would be highly illiquid. See *id.*

240. See Beese, *supra* note 2.

241. See, e.g., *supra* notes 202-204 and accompanying text.

242. See Devere, *supra* note 24 (pointing to Latin America as an untapped region looking to link into international capital markets).

243. See Devere, *supra* note 24.

244. See Tina Podplatnik and Sergei Skatershchikov, *Stock Market Bulls Set for Round Two*, MOSCOW TIMES, June 25, 1996. In Russia, for example, Flemings Russian Securities Fund has dedicated about 30 percent of its investments in the illiquid securities of second tier companies. *Id.*

it typically invests, is in its formative years.²⁴⁵ Its future is premised on the ultimate success of investors willing to place their capital in a foreign company presenting higher risk along with the promise of a higher return.²⁴⁶ Foremost among the investor's concerns in making the initial investment, as well as during the subsequent development of the company, is the availability of viable exit mechanisms.²⁴⁷ One observer described investors who have made long-term, illiquid investments in foreign companies by stating, "Their eyes are always on the exits."²⁴⁸

Accessing the United States capital markets as an exit represents a particularly attractive option. Successful utilization of this exit, however, will require the private equity investor to play an essential role in preparing the company for the United States market. It is likely that such an investor will become an important adviser to the company in which it invests. The insight and acumen of the private equity investor will be integral to plotting the structures and strategies necessary for a successful United States offering by a foreign company, including driving consideration of whether to establish an ADR program, conduct a United States public offering, gain a listing on the over-the-counter market, or reach institutional investors through a private placement of equity. The historical assumption that United States capital markets are inaccessible to the foreign company in its formative years, from an emerging market, or with a smaller level of capitalization than the typical foreign issuer, is gradually giving way to reflect the nature of the evolving and increasingly interconnected world capital markets.

245. See INVESTMENT FUNDS IN EMERGING MARKETS, *supra* note 32, at 2.

246. See FENN, *supra* note 6, at 17-21.

247. See Brad Durham, *Financing the West's Russian Spree*, GLOBAL FIN., July 1996, at 48.

248. See *id.*