

“PUSHING THE ENVELOPE”^{*} OF THE REGULATION S SAFE HARBORS

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^{*} *Issuers ‘Pushing Envelope’ of Reg S Safe Harbor, Quinn Warns*, 26 Sec. Reg. & L. Rep. (BNA) No. 10, at 355 (Mar. 11, 1994) (quoting Linda Quinn, Director of SEC’s Corporate Finance Division).

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INTRODUCTION

The adoption of Regulation S (Reg. S or Regulation S)¹ in the spring of 1990 was a pivotal step toward ensuring that U.S. securities laws do not leave U.S. investors unable to invest and compete in foreign markets.² In turn, Regulation S further integrated U.S. capital markets with those of the rest of the world.³ The Securities and Exchange Commission (SEC or Commission) intended the rule to assist sizable, financially sound companies in selling securities to long-term European investors without complying with the excessive registration requirements of the Securities Act of 1933 (1933 Act).⁴

1. Offshore Offers and Sales, Securities Act Release No. 33-6863, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,524, at 80,661 (Apr. 24, 1990) [hereinafter Adopting Release]; see also Regulation S—Rules Governing Offers and Sales Made Outside the United States Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.901-904 (1995) [hereinafter Reg. S] (codifying SEC's interpretation of extraterritorial application of 1933 Act's registration provisions).

2. See Samuel Wolff, *Offshore Distributions under the Securities Act of 1933: An Analysis of Regulation S*, 23 LAW & POL'Y INT'L BUS. 101, 105 (1991/1992) (recognizing Reg. S as major reconceptualization in law allowing U.S. persons to purchase securities in offshore markets); see also Joel P. Trachtman, *Recent Initiatives in International Financial Regulation and Goals of Competitiveness, Effectiveness, Consistency and Cooperation*, 12 NW. J. INT'L L. & BUS. 241, 292 (1991) (noting intent of Reg. S to facilitate U.S. investors providing financing in foreign capital markets).

3. See Wolff, *supra* note 2, at 101 (announcing that internationalization of securities markets, including U.S. market, got underway with adoption of Reg. S (citing Marilyn Mooney, *Path Is Cleared for Non-U.S. Issuers*, FIN. TIMES, May 3, 1990, at 14)).

4. The Securities Act of 1933, ch. 38, § 1, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a-77aa (1994)). According to Sara Hanks, the author of Regulation S, the Securities and Exchange Commission (SEC or Commission) determined that U.S. companies did not need to register their securities when selling to overseas buyers because those buyers are not governed by U.S. securities laws. See Laurie P. Cohen, *Rule Permitting Offshore Stock Sales Yields Deals That Spark SEC Concerns*, WALL ST. J., Apr. 26, 1994, at C1. Eliminating registration requirements expedited overseas sales. *Id.*

Instead, Regulation S has prompted a horde of “shady transactions”⁵ by companies using it to evade the 1933 Act’s registration requirements.⁶

The 1933 Act, also known as the “Truth in Securities” Act,⁷ is primarily aimed at the distribution of securities.⁸ It seeks to extend “full and fair disclosure”⁹ of the nature of securities sold in interstate commerce, foreign commerce, and via the mails¹⁰ by requiring registration of all securities offered to the public for the first time.¹¹ The philosophy behind the 1933 Act is that investors are sufficiently protected if all aspects of the marketed securities are adequately and accurately disclosed.¹² The 1933 Act also tries to prevent fraud in the sale of such securities by providing a general anti-fraud provision that prohibits material misrepresentations or omissions in connection with the sale of securities.¹³

Partly because the 1933 Act is limited in scope—it applies only to securities distributions, and it safeguards only securities purchasers¹⁴—Congress enacted the Securities and Exchange Act of 1934 (1934 Act).¹⁵ The 1934 Act is much broader in scope than the 1933 Act and as such, it extends the mandate of investor protection by disclosure to securities traded publicly on national securities exchanges.¹⁶ The goal of the 1934 Act is to regulate all facets of public trading of securities.¹⁷

5. See Cohen, *supra* note 4, at C1 (observing that “four years after Regulation S was enacted . . . the rule has resulted in a host of shady transactions by companies and buyers using it to evade registration requirements”).

6. Cohen, *supra* note 4, at C1.

7. 15 U.S.C. § 77a; 1 THOMAS L. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 7 (1990).

8. HAZEN, *supra* note 7, at 7.

9. 15 U.S.C. § 77a.

10. *Id.*

11. See HAZEN, *supra* note 7, at 7 n.3 (recognizing that registration requirement includes secondary distributions where securities are sold by individuals or institutions that did not obtain securities in public offering); see also OFFICE OF PUB. AFFAIRS, U.S. SEC. AND EXCH. COMM’N, THE WORK OF THE SEC 8 (1988) [hereinafter THE WORK OF THE SEC] (stating that registration forms provide necessary facts while minimizing burden and expense of compliance).

12. See HAZEN, *supra* note 7, at 7 (expounding theory behind federal regulatory framework); see also THE WORK OF THE SEC, *supra* note 11, at 7 (stating that, unlike adequacy, accuracy of disclosure is not guaranteed by registration).

13. HAZEN, *supra* note 7, at 7.

14. HAZEN, *supra* note 7, at 7 (recognizing limited scope of 1933 Act).

15. The Securities and Exchange Act of 1934, ch. 404, § 1, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78ll (1994)).

16. See THE WORK OF THE SEC, *supra* note 11, at 11 (noting that 1934 Act attempts to ensure fair and orderly markets by banning certain activities and promulgating rules regarding markets’ operation and participants).

17. See HAZEN, *supra* note 7, at 7-8 (terming 1934 Act as more “omnibus” regulation than 1933 Act because of its vast scope).

Essentially, the purpose of both the 1933 and 1934 Acts is to facilitate informed investment decisions by ensuring adequate disclosure of material information.¹⁸ Nevertheless, while registration requirements generally apply to both domestic and foreign issuers' securities, certain securities qualify for exemption from registration because they satisfy specified conditions.¹⁹

Regulation S is one such exemption from the registration requirements of section 5 of the 1933 Act.²⁰ Essentially, Regulation S codified a series of rules that collectively adopt a "territorial" approach toward section 5.²¹ Specifically, if a securities transaction occurs within the United States, registration is required.²² If, however, the transaction takes place outside the United States, then no registration is necessary.²³ Regulation S created two safe harbor provisions for offshore sales of unregistered securities: an issuer safe harbor and a resale safe harbor.²⁴ These safe harbors enable some issuers to avoid legal consequences when they sell their securities offshore without U.S. registration.²⁵ By satisfying certain conditions and/or complying with specified restrictions, as described below, an issuer or distributor's offer or sale of securities is considered to be outside of the United States and, consequently, exempt from the onerous registration requirements of the 1933 Act.²⁶

From Regulation S's inception, the financial community recognized an about-face for the SEC with respect to its approach to section 5's registration provisions.²⁷ Instead of continuing its expansive view of

18. THE WORK OF THE SEC, *supra* note 11, at 5 (denoting laws as facilitating informed investment analysis by ensuring proper disclosure from publicly held entities, broker-dealers in securities, investment companies and advisers, and other participants in securities markets).

19. THE WORK OF THE SEC, *supra* note 11, at 10 (stating that conditions include prior filing of notification with SEC regional office and use of offering circular containing basic information on sale of securities).

20. Wolff, *supra* note 2, at 105.

21. SEC Releases *Proposals on International Transactions*, 20 Rev. Sec. Reg. & L. Rep. (BNA) No. 24, at 912 (June 17, 1988) [hereinafter *SEC Releases*] (stating intent of Reg. S as adopting territorial approach to registration requirements).

22. Trachtman, *supra* note 2, at 295.

23. Trachtman, *supra* note 2, at 295.

24. See John R. Coogan & Thomas C. Kimbrough, *Regulation S Safe Harbors for Offshore Offers, Sales and Resales*, 4 Insights (P-H) No. 8, at 3 (Aug. 1990) (noting creation of two safe harbors); Wolff, *supra* note 2, at 106 (listing two types of safe harbors).

25. See ALLAN H. PESSIN & JOSEPH A. ROSS, *THE COMPLETE WORDS OF WALL STREET* 607 (1991) (describing "safe harbor" as financial term denoting that action avoids legal or tax consequences).

26. See Coogan & Kimbrough, *supra* note 24, at 3 (reiterating that 1933 Act registration requirements do not apply to offshore offers and sales); Wolff, *supra* note 2, at 106 (elaborating on Reg. S provisions for offers and sales outside United States).

27. 15 U.S.C. § 77(e) (1994). Section 5 makes it unlawful for any person to "make use of any means of . . . interstate transportation or communication or of the mails" in connection with the offer or sale of unregistered securities. *Id.* Interstate transportation, or interstate

the extraterritorial²⁸ application of U.S. securities laws, the SEC recognized principles of comity²⁹ and ultimately adopted a territorial approach to the registration requirements.³⁰ The SEC perceived Regulation S as begetting "a profound and beneficial effect upon the ability of issuers to raise capital in the context of today's global marketplace, and [as enhancing] the competitiveness and efficiency of our domestic markets."³¹ Indeed, investors have raised a great

commerce, is defined in § 2(7) of the 1933 Act, 15 U.S.C. § 77(b)(7) (1994), to include "trade or commerce in securities or any transportation or communication relating thereto . . . between any foreign country and any State, Territory or the District of Columbia." This language is similar to that found in the Commerce Clause of the United States Constitution. U.S. CONST. art. I, § 8, cl. 3. Because of the broad jurisdictional base of the 1933 Act, the necessity for Reg. S is obvious: it curtails the potential long-arm reach of U.S. securities laws registration requirements. See *Transnational Aspects of U.S. Securities Laws*, 10B Int'l Capital Markets & Sec. Reg. (Clark Boardman) § 5.01[4], at 5-19 (1990) [hereinafter *Transnational Aspects*] (citing potential far reach of 1933 Act's registration requirements as basis for Reg. S); see also Wolff, *supra* note 2, at 102, 104 (characterizing Reg. S generally as change in entire legal composition underlying U.S., and some foreign, companies' involvement in international securities transactions, and specifically as change in Commission's definition of extraterritorial application of 1933 Act's registration provisions); *infra* notes 45-47 and accompanying text (explaining jurisdiction under § 5 and defining interstate commerce as it applies to § 5 of 1933 Act, 15 U.S.C. § 77(e) (1994)).

28. See BLACK'S LAW DICTIONARY 588 (6th ed. 1990) (defining extraterritorial as "beyond the physical and judicial boundaries of a particular state or country"); see also Adopting Release, *supra* note 1, at 80,665 (acknowledging that Reg. S limits extraterritorial application of § 5 registration provisions). In the release adopting Reg. S, the Commission states that "[t]erritoriality is a fundamental basis for jurisdiction under both international law . . . and the foreign relations law of the United States." *Id.* at n.19 (citing RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 402 (1987) and other sources of international and foreign relations law).

While Reg. S relates to the registration requirements of § 5, it does not limit the extraterritorial application of the 1933 Act's antifraud provisions. See Adopting Release, *supra* note 1, at 80,665. If fraudulent conduct occurs within the United States or has a significant effect within the United States, the antifraud provisions apply. *Id.* For a more thorough discussion of the extraterritorial affect of law, see Wolff, *supra* note 2, at 156-59 nn.351-74 and accompanying text (relating 1933 Act's extraterritorial application to concepts of international jurisdiction).

29. See BLACK'S LAW DICTIONARY, *supra* note 28, at 267 (defining comity as "giv[ing] effect to the laws and judicial decisions of another state or jurisdiction, not as a matter of obligation but out of deference and mutual respect"); Adopting Release, *supra* note 1, at 80,665 n.20 and accompanying text (defining comity as doctrine that "emphasizes restraint and tolerance by nations in international affairs"); see also Trachtman, *supra* note 2, at 294 (noting Commission's consideration of comity as important factor in determining scope of § 5 registration requirements).

30. Adopting Release, *supra* note 1, at 80,665 (stating that "territorial approach acknowledges the primacy of the laws in which a market is located"); see also Michael R. Gibbons, Comment, *SEC Proposed Regulation S: After Twenty-Five Years of Drifting, a New Safe Harbor for Foreign Offerings*, 21 U. MIAMI INTER-AM. L. REV. 357, 365 (1989/1990) (reiterating territorial approach adopted by SEC in defining scope of § 5 registration requirements); *infra* notes 74, 89-111 and accompanying text (elaborating on general territorial approach to Reg. S as reflected in definition of "U.S. person").

31. Andrea F. Bradley, *Regulation S: Tempest in a Safe Harbor*, 25 Rev. Sec. & Commodities Reg. (S&P) No. 17, at 185 (Oct. 7, 1992) (quoting opening remarks of Richard C. Breeden, Chairman of SEC, Apr. 19, 1990).

deal of capital with the aid of Regulation S.³² In fact, Regulation S was recently touted as "one step away from venture capital."³³

In addition to enhancing the United States' competitiveness in global markets, Regulation S is already being exploited, for better or for worse, as a significant means of financing for new companies looking for quick money.³⁴ Investors taking part in Reg. S offerings are exploiting the Regulation as well. For example, in April 1993, Primerica, Corp. (now called Travelers, Inc.), a large healthy company, sold seven million of its shares in a Regulation S offering.³⁵ The offering price was between \$42.75 and \$43.25 per share, discounted from the then U.S. market price of \$46.125 per share.³⁶ Although Primerica did not tell its U.S. shareholders about the offshore offering, the company's stock fell sharply the day after it completed the offering.³⁷ The sharp decline in Primerica's stock was due to European investors buying the discounted Regulation S stock abroad and simultaneously selling short Primerica's stock in the United States.³⁸ Essentially, the short-sellers borrowed Primerica stock from a broker and immediately sold it, hoping that the price would decline.³⁹ After the Reg. S stock's restricted period expired, the short-seller replaced the broker's stock with the cheaper Reg. S

32. See Cohen, *supra* note 4, at C1 (announcing that Reg. S offerings and sales are becoming increasingly fashionable technique to raise money). Cohen reports that while no one tracks these unregistered transactions, it is believed that billions of dollars have been raised over the past four years in Reg. S deals. *Id.*; see also Charles Fleming, *Europe's Fund Managers Say Offers of 'Reg-S' Shares Are Proliferating*, WALL ST. J. EUR., Mar. 29, 1994, at 13 (noting that investors and investment authorities believe that while Reg. S issues are "quick and cheap way for non-U.S. institutions to buy good American stocks," they are high-risk and potentially hazardous).

33. Fleming, *supra* note 32, at 13 (quoting Christopher Jenkins, head of TSB OIF Pan-American Fund for Britain's TSB Group). One author defines venture capital as the "[i]ndustry term for an investment in a new, untried business venture with all of the financial risks inherent in such an enterprise." PESSIN & ROSS, *supra* note 25, at 770. The companies that specialize in such investments usually require a large amount of equity ownership in the business as part of their recompense. *Id.* Consequently, if the chancy undertaking prospers, the venture capital company is generously compensated. *Id.*

34. Fleming, *supra* note 32, at 13 (relating opinion of Toronto-based investment banker, Bruce Bailey, that Reg. S offerings save substantial portion of cost of public issue and notably reduce time involved in registering issue with SEC for companies looking for swift prudent project financing). One estimate suggests that six billion dollars has been raised through Reg. S issues since 1990; another indicates that Reg. S issues already equal five percent of all U.S. initial public offerings. *Id.* See generally Cohen, *supra* note 4, at C1 (noting that Reg. S offerings are increasingly popular with companies wanting to raise money).

35. Cohen, *supra* note 4, at C1.

36. Cohen, *supra* note 4, at C1.

37. Cohen, *supra* note 4, at C1.

38. Cohen, *supra* note 4, at C1; see also *infra* notes 306-23 and accompanying text (elaborating on strategy of short-selling).

39. Cohen, *supra* note 4, at C1; see also *infra* notes 306-23 (describing how short sale occurs).

stock and profited from the difference.⁴⁰ In response to initial reports of Reg. S's misuse and abuse,⁴¹ Congress recently expressed interest in revisiting, revising, and perhaps even repealing the 1933 Act exemption.⁴² Finally, after more than a year of warnings that Reg. S abuses may be severe enough to warrant a review of the rules, the SEC has issued an interpretive release to address such problematic practices.⁴³

This Comment examines the potential problems created by the securities industry's exploitation of its newest valuable resource, Regulation S. Part I presents a brief overview of the historical context that led to the development of Regulation S, including a glimpse at its predecessor, Release 4708. Part II analyzes the structure and intended use of Regulation S as an exemption to the 1933 Act's section 5 registration requirements. Part III examines the Regulation's Preliminary Note 2 and summarizes accusations regarding actual uses of Regulation S that apparently disregard the SEC's intentions. In particular, Part III explains the process of short-selling and the reasons for which it is employed with respect to Regulation S securities. Finally, Part IV explores the need for SEC enforcement or amendment of the Regulation in light of recent allegations.⁴⁴ Part IV includes a specific proposal for amending Regulation S that would likely curb these unanticipated transactions while maintaining

40. Cohen, *supra* note 4, at C1 (proffering short-selling as example of Reg. S loophole that SEC did not intend).

41. See *SEC Staff Reviewing Best Way to Deal with Reg. S Offshore Offering Problem*, 26 Sec. Reg. & L. Rep. (BNA) No. 19, at 696 (May 13, 1994) [hereinafter *SEC Staff*] (mentioning SEC Commissioner Richard Roberts' misgivings that Reg. S offerings are arranged solely to remove restrictions from securities prior to securities re-entering United States); *SEC's Waller Highlights Concern Over Application of Regulation S*, 26 Sec. Reg. & L. Rep. (BNA) No. 10, at 366 (Mar. 11, 1994) [hereinafter *SEC's Waller*] (outlining SEC apprehensions that companies are making considerable placements abroad at considerable discounts and that often placements are made merely to companies' affiliates); Cohen, *supra* note 4, at C1 (alleging that companies are trying to capitalize on Reg. S and pointing to evasion of registration requirements as possible result); Fleming, *supra* note 32, at 13 (describing general attitudes of European fund managers regarding unintended uses of Reg. S). See generally Issuers 'Pushing Envelope' of Reg. S Safe Harbor, *Quinn Warns*, 26 Sec. Reg. & L. Rep. (BNA) No. 10, at 355 (Mar. 11, 1994) [hereinafter *Pushing Envelope*] (discussing SEC concern that too many people are "pushing envelope" of Reg. S's safe harbor).

42. See Letter from Rep. Edward Markey to SEC (Apr. 27, 1994) [hereinafter *Markey Letter*] (on file with *The American University Law Review*) (requesting report responding to allegations of widespread abuses of Reg. S); see also *Markey Seeks Report on Reg. S*, 26 Sec. Reg. & L. Rep. (BNA) No. 17, at 636 (Apr. 29, 1994) [hereinafter *Report on Reg. S*] (summarizing letter in which Rep. Markey sought report from SEC on whether rule should be substantially revised or repealed); *SEC Staff, supra* note 41, at 696 (citing letter from Rep. Markey requesting that SEC revisit Reg. S after indication of abuses).

43. *Problematic Practices Under Regulation S*, 60 Fed. Reg. 35,663 (1995) (to be codified at 17 C.F.R. § 231) [hereinafter *Problematic Practices*].

44. See *Problematic Practices, supra* note 43, at 35,664 (considering whether revision of Reg. S is necessary to prevent abusive practices and requesting comment regarding same).

the Regulation's original intent. Part IV also notes the dearth of workable solutions that the SEC may encounter while it revisits Regulation S. In general, this Comment scrutinizes the SEC's delayed effort, first to document the existence of reported "abuses" of Regulation S, and then to evaluate their impact to determine if the misuses have already risen, or threaten to rise, to a level that requires remedial measures.

I. HISTORICAL CONTEXT OF REGULATION S AND THE EXTRATERRITORIAL APPLICATION OF SECTION 5

In its simplest form, section 5 of the 1933 Act links the registration requirement for the sale of securities with the use of interstate commerce.⁴⁵ Generally, section 5 requires registration of all non-exempt offers and sales of securities that use instruments or means of communication, transportation in interstate commerce, or the mails.⁴⁶ In the context of the 1933 Act's registration provisions, interstate commerce is defined as "trade or commerce in securities or any transportation or communication relating thereto among the several States . . . or between any foreign country and any State."⁴⁷

At the time Congress enacted the Securities Act of 1933, relatively few international securities offerings occurred.⁴⁸ As a result, the immediate effect of the statute on global markets was unknown and untested.⁴⁹ Accordingly, the scope of the 1933 Act tended to be interpreted literally and, therefore, very broadly.⁵⁰ In practice, the

45. See Wolff, *supra* note 2, at 111 n.63 (arguing that 1933 Act registration provisions apply to use of any means of interstate commerce (citing SEC v. United Fin. Group, Inc., 474 F.2d 354 (9th Cir. 1973))). See generally 15 U.S.C. § 77e (1994).

46. 15 U.S.C. § 77e(a)(1) (1994). Section 5 states: "Unless a registration statement is in effect . . . it shall be unlawful for any person, directly or indirectly . . . to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use . . . of any prospectus or otherwise . . ." *Id.*; see also Trachtman, *supra* note 2, at 294 (restating application of § 5 to all non-exempt offers and sales of securities in interstate commerce); Wolff, *supra* note 2, at 108 (explaining need for registration under § 5 of 1933 Act because of use of interstate commerce); *supra* note 27 (expanding on requirements of § 5 and defining interstate commerce).

47. 15 U.S.C. § 77(b)(7) (1994); see also Wolff, *supra* note 2, at 108-09 (restating definition of interstate commerce).

48. See Wolff, *supra* note 2, at 109 & n.46 (citing INTERNATIONALIZATION REPORT, *infra* note 52, at III-313 regarding recent growth in international markets).

49. See Wolff, *supra* note 2, at 108 (characterizing effect of statutory scheme on international finance as non-salient in 1933).

50. See Adopting Release, *supra* note 1, at 80,664 (attributing potential problems for companies raising funds abroad to 1933 Act's broad jurisdictional reach). In the introduction to Reg. S, the Commission admitted that one of the principle concerns for companies raising capital abroad was "the reach across national boundaries of the registration requirements under § 5 of the Securities Act." *Id.*; see also Coogan & Kimbrough, *supra* note 24, at 3 (suggesting that 1933 Act may be read broadly to include any offer or sale concerning interstate commerce). Historically, the SEC has maintained the position that "the actual reach of the registration

1933 Act encompassed any offer or sale involving the use of the mails or interstate commerce unless an exemption applied.⁵¹ Because of the growing number of international offerings,⁵² however, the SEC found it necessary to formalize its opinion regarding the extraterritorial application of U.S. securities laws.⁵³

A. Release 4708: The Predecessor

Release 4708,⁵⁴ promulgated in 1964, was the SEC's first attempt to define the extraterritorial reach of the 1933 Act's registration requirements.⁵⁵ This Release provided that no enforcement action

requirements [of the 1933 Act] is not as extensive as their broadest possible reading." Coogan & Kimbrough, *supra* note 24, at 3. The primary purpose of the registration requirements was to protect U.S. investors. *Id.* at 3-4.

51. Securities Act of 1933, § 5, 15 U.S.C. § 77e; see Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1335 (2d Cir. 1972) (maintaining that § 17(a) of 1933 Act applies to all fraudulent offers or sales of securities in commerce or by use of mails); Adopting Release, *supra* note 1, at 80,664 n.12 (finding that mails and other facilities of interstate commerce were employed for preparing and distributing prospectuses, arranging sales meetings, and perfecting transactions (citing SEC v. United Fin. Group, Inc., 474 F.2d 354, 357 (9th Cir. 1973))); see also Coogan & Kimbrough, *supra* note 24, at 3-4 (noting that SEC historically has not read requirements broadly, applying registration requirements on national and territorial bases only).

52. Gibbons, *supra* note 30, at 358 (recognizing "revolutionary advances" in international financial markets); see also Adopting Release, *supra* note 1, at 80,664 (specifying active international trading market as one of several reasons for clarifying application of § 5). For example, according to SEC staff, the international bond market alone grew tremendously: from \$38 billion in 1980 to \$254 billion in 1986. INTERNATIONALIZATION OF THE SECURITIES MKTS.: REPORT OF THE STAFF OF THE SEC. & EXCH. COMM'N TO THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS AND THE HOUSE COMM. ON ENERGY AND COMMERCE, I-1 (July 27, 1987) [hereinafter INTERNATIONALIZATION REPORT]. The extraterritorial application of § 5, which had been an issue for a long time, only recently became of vital importance with "the development and maturity of major markets offshore and the huge growth of transnational investment." *Id.* at III-313. Consequently, "[t]he recent development of active international trading markets[,] . . . the significant increase in offshore offerings of securities, [and] the significant participation by United States investors in foreign markets, have heightened the need to revisit the parameters of the registration provisions." *Id.* at III-315; cf. Wolff, *supra* note 2, at 109 (maintaining that effect of statutory scheme on international finance was unknown at time of 1993 Act because of lack of international securities offerings).

53. Cf. Wolff, *supra* note 2, at 112 (stating that "Release 4708 defined the extraterritorial application of § 5 from its issuance in 1964"). See generally Gibbons, *supra* note 30, at 360 (observing that SEC's issuance of Release 4708 was based on pressure to allow U.S. companies to raise capital abroad more effectively); *Transnational Aspects*, *supra* note 27, § 5.01[1], at 5-4 (attributing Reg. S to SEC staff's new focus on international capital markets and realization that old policy, determined through no-action letters, was impediment).

54. Registration of Foreign Offerings by Domestic Issuers, Securities Act Release No. 33-4708, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶1 1361-62 (July 9, 1964) [hereinafter Release 4708]; see also Coogan & Kimbrough, *supra* note 24, at 3 (reiterating that Release 4708 was based on attitude that registration requirements are primarily intended to protect U.S. investors); Gibbons, *supra* note 30, at 360 (stating that Release 4708 was SEC's attempt to clarify extraterritorial reach of federal securities laws).

55. See Leslie N. Silverman & Daniel A. Braverman, *Regulation S and Other New Measures Affecting the International Capital Markets*, 23 Rev. Sec. & Commodities Reg. (S&P) No. 18, at 179 (Oct. 17, 1990) (stating that Release 4708 was SEC's first attempt to define reach of § 5); see also Bradley, *supra* note 31, at 185 (maintaining that Release 4708 was "Commission's first attempt to address the application of the federal securities laws to transactions involving non-U.S. issuers

would ensue against U.S. corporations that distribute unregistered securities abroad solely to foreign nationals, even though these distributions utilized interstate commerce.⁵⁶ Reliance upon Release 4708, however, required that the distribution be effected in such a manner that the unregistered securities came to rest abroad.⁵⁷

Release 4708 attempted to define the reach of the section 5 registration requirements by setting out general standards for their application.⁵⁸ According to Release 4708, the requirements were applied on both a territorial basis—no distributions of unregistered securities within the United States—and a national basis—no distributions to U.S. persons, even those living outside the United States.⁵⁹ The SEC's position in Release 4708 of foregoing enforcement proceedings in certain instances⁶⁰ remained consistent with the policy underlying section 5 "to protect American investors."⁶¹

After Release 4708 was published, lawyers and other securities experts developed procedures to ensure that securities sold in reliance on the Release would not be distributed in the United States or to

and purchasers").

56. Release 4708, *supra* note 54, ¶ 1361; see Adopting Release, *supra* note 1, at 80,664 (reiterating Commission's position with respect to Release 4708). In the background to Reg. S, the Commission points out that Release 4708 has been applied to offerings by foreign issuers even though the Release specifically refers only to domestic issuers. *Id.* (citing no-action letters regarding Vizcaya International N.V., 1973 SEC No-Act. LEXIS 1935 (Apr. 4, 1973) and Republic of Iceland, 1971 SEC No-Act. LEXIS 2554 (Mar. 19, 1971) for support); see also Coogan & Kimbrough, *supra* note 24, at 4 (announcing that Release 4708 codified SEC's position that it would not take enforcement action for U.S. issuers' securities distributions abroad to foreign nationals); Gibbons, *supra* note 30, at 360 (discussing Release 4708 as SEC's decision not to take enforcement action against U.S. corporations for distribution of unregistered securities abroad). See generally Wolff, *supra* note 2, at 110-11 (explaining Release 4708).

57. Release 4708, *supra* note 54, ¶ 1360. Release 4708, like Reg. S, deals only with the scope of the registration requirements of § 5 and has no effect on the antifraud provisions of the securities laws. In this Release, the SEC concluded that U.S. companies could issue unregistered securities if "the offering is made under circumstances reasonably designed to preclude distribution or redistribution of the securities within, or to nationals of, the United States." *Id.* ¶ 1362; see also Gibbons, *supra* note 30, at 361 (quoting Release 4708); Silverman & Braverman, *supra* note 55, at 179 (quoting Release 4708); Wolff, *supra* note 2, at 110 (discussing Release 4708).

58. Gibbons, *supra* note 30, at 361.

59. Coogan & Kimbrough, *supra* note 24, at 4.

60. See *supra* note 56 and accompanying text (listing examples of no-action letters where SEC determined that purpose of Release 4708, investor protection, did not require enforcement of registration requirement).

61. Release 4708, *supra* note 54, ¶ 1362; see also Gibbons, *supra* note 30, at 361 (equating Release 4708 with SEC intention to forego enforcement action against U.S. issuers completing offshore distributions of unregistered securities); Silverman & Braverman, *supra* note 55, at 179 (quoting primary intention of Release 4708); Wolff, *supra* note 2, at 110-11 (recognizing SEC's position with respect to Release 4708 that it would not initiate enforcement actions for failure to register).

U.S. nationals.⁶² Such procedures quickly became the subject of numerous no-action letters issued by the SEC staff,⁶³ which essentially responded to requests from parties considering actions potentially restricted by U.S. securities laws.⁶⁴ While the SEC staff answered many questions that the Release raised,⁶⁵ the staff did not express any conclusive view concerning resales of Release 4708 securities within the United States or to U.S. persons.⁶⁶ Consequently, Release 4708 failed to provide the degree of certainty necessary for corporations involved in offerings of unregistered securities.⁶⁷

62. Gibbons, *supra* note 30, at 361; *see also* Adopting Release, *supra* note 1, at 80,664 (describing procedures as those to ensure that securities are sold to non-U.S. persons and come to rest abroad). Although a more detailed discussion of Release 4708 is beyond the scope of this Comment, it is important to note the specific procedures that the SEC developed to ensure that these conditions were met. In general, they required: (1) a 90-day "lock-up" period for the securities, beginning upon the completion of the distribution, and subsequent release of the definitive securities upon certification of non-U.S. beneficial ownership; (2) underwriters' agreement not to sell unsold allotments within the United States or to U.S. persons at any time, or not to sell other securities until the "lock-up" ended; and (3) delivery of confirmations imposing sales restrictions on the underwriter, including the requirement to deliver confirmations to dealers purchasing securities from them. Release 4708, *supra* note 54, at ¶ 1361; *see also* Silverman & Braverman, *supra* note 55, at 180 (summarizing Release 4708's provisions).

63. *See* PESSIN & ROSS, *supra* note 25, at 465. A no-action letter is an SEC response to a request for a specific opinion from a party contemplating a potentially prohibited action under U.S. securities laws. *Id.* The no-action letter, in effect, signifies that the SEC will not bring either civil or criminal enforcement action if the activity occurs as indicated by the party's letter. *Id.* No-action letters are inquirer-specific and apply only to the circumstances outlined in the inquiry. *Id.*

64. Adopting Release, *supra* note 1, at 80,664 n.16 (citing numerous no-action letters, including InfraRed Associates, Inc., 1985 SEC No-Act. LEXIS 2557 (Sept. 16, 1985); Raymond Int'l Inc., (June 28, 1976); and Pan American World Airways, Inc. (June 30, 1975)).

65. *See, e.g.,* College Retirement Equities Fund, SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,420, at 77,362 (Feb. 18, 1987) [hereinafter CREF] (construing Release 4708 to allow overseas resales of securities not obtained in reliance on Release 4708); French Privatization Program, SEC No-Action Letter, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,439, at 77,435 (Apr. 17, 1987) [hereinafter French Privatization] (permitting securities offering pursuant to Release 4708 to include sales to U.S. citizens residing in France); *see also* Wolff, *supra* note 2, at nn.83-94 and accompanying text (describing certain no-action letters written prior to Reg. S that outline significant positions subsequently taken in Reg. S).

66. Adopting Release, *supra* note 1, at 80,664. In Proctor & Gamble Co., SEC No-Action Letter, 1985 WL 61525, at * 2, *3 (Feb. 21, 1985), the SEC staff indicated that resales must comply with the 1933 Act registration requirements or fall within an exemption. *Id.* at 80,664 & n.18.

67. Bradley, *supra* note 31, at 185. Although advances in computer technology and telecommunications were overcoming information obstacles among world markets, regulatory obstacles remained because Release 4708 continued to prevent corporations from determining with reasonable confidence whether a potential deal would be subject to § 5 registration requirements. *Id.*; *see* Gibbons, *supra* note 30, at 361 (determining that registration exemption in Release 4708 was too general and failed to provide adequate certainty of result); *cf.* Silverman & Braverman, *supra* note 55, at 180 (professing that cooperative efforts yield degree of certainty).

B. Regulation S: The Genesis

In addition to leaving fundamental questions unanswered,⁶⁸ Release 4708 was viewed as an obstacle to transnational offerings created by the extraterritorial application of section 5.⁶⁹ Not only did Release 4708 effectively increase the cost of raising capital for U.S. issuers,⁷⁰ it also denied alluring global investment opportunities to a group of potential investors because of their status as U.S. persons.⁷¹ Under Release 4708, securities offered to a U.S. citizen anywhere in the world would need to comply with the registration requirements of the 1933 Act.⁷² The touchstone for section 5's application, therefore, was the purchaser's identity rather than the location of the transaction.⁷³ In contrast, a territorial approach to

68. Silverman & Braverman, *supra* note 55, at 180. Many questions remained unanswered after Release 4708, including the precise application of the release and the release's application to continuous offerings. *Id.* See generally Adopting Release, *supra* note 1, at 80,664 (highlighting continued existence of questions under U.S. securities laws, especially regarding international reach of § 5 registration requirements).

69. See Wolff, *supra* note 2, at 112-13 (describing Release 4708 as "obstacle to international transactions"). In 1986, a witness at a Congressional hearing articulated the popular sentiment that too much regulation is itself an obstacle. He said:

[I]f we regulate too much, we will lose the game because companies will . . . trade in markets that are unregulated [T]he very regulations we impose will be counterproductive to our overall objectives, because so much . . . business will [try to] escape these regulations . . . that, in effect, we will lose the ability to . . . regulat[e] at all

Id. at 112 (quoting Robert D. Hormats, Vice President, Goldman, Sachs & Co., *The Internationalization of the Capital Markets: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 99th Cong., 2d Sess. 72 (1986)). A similar opinion was expressed fifteen years earlier by Chief Justice Warren Burger who cautioned that "[w]e cannot have trade and commerce in world markets and international waters exclusively on our terms, governed by our laws." *Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 8 (1972).

70. See INTERNATIONALIZATION REPORT, *supra* note 52, at III-312 (noting that Release 4708 was impediment to international offers and sales); see also Wolff, *supra* note 2, at 112-13 n.70 (citing SEC Releases *Proposals on International Transactions*, 20 Sec. Reg. & L. Rep. (BNA) No. 24, at 912 (June 17, 1988)).

71. See INTERNATIONALIZATION REPORT, *supra* note 52, at III-311, III-315, III-316 (commenting on Release 4708's definition of U.S. person and its effect on investment opportunities for people wanting to invest globally); see also Wolff, *supra* note 2, at 112-13 (recognizing that under Release 4708, U.S. persons were denied investment opportunities). The change in the definition of "U.S. person" is the fundamental difference between Release 4708 and Reg. S. While Release 4708's jurisdiction applied extraterritorially to securities offered or sold to U.S. citizens anywhere in the world, Reg. S confines the application of § 5 to a territorial basis. Wolff, *supra* note 2, at 118-19. Under the Reg. S regime, a U.S. person is anyone who is a resident of the United States at the time of the offer or sale. Reg. S, *supra* note 1, at § 230.902(o)(1)(i). The SEC was thus able to expound its new policy of "protect[ing] the U.S. capital markets and investors purchasing in the U.S. market." Adopting Release, *supra* note 1, at 80,665; see also *infra* notes 72-75 and accompanying text (discussing difference between treatment of "U.S. person" under Release 4708 and under Reg. S).

72. See Coogan & Kimbrough, *supra* note 24, at 4 (stressing that application of registration provisions under Release 4708 was on both national and territorial basis).

73. See Wolff, *supra* note 2, at 118 (declaring residency as determinative of who is treated as U.S. person for purposes of § 5).

the registration requirement would shift section 5's focus to the place where the transaction occurs⁷⁴ and subsequently allow U.S. investors to take advantage of global investments.⁷⁵

Before the SEC started the actual rulemaking process, it began effecting its new "territorial" philosophy through no-action letters, speeches, and reports by SEC staff members.⁷⁶ Gradually, the important policy considerations that would be embodied in Regulation S became apparent: principles of comity and expectations of participants in global markets require the United States to recognize the laws of other financial markets.⁷⁷ The SEC accepts this so-called "mutual recognition"⁷⁸ philosophy because it remains consistent with the SEC's goal of protecting U.S. investors purchasing securities in the secondary market.⁷⁹ Investor protection is ensured by reliance on

74. See Wolff, *supra* note 2, at 113-14 (advancing position of SEC's Director of Division of Corporate Finance, Linda Quinn, that it is inappropriate for SEC to suggest that securities offered to U.S. citizen anywhere in world comply with 1933 Act). The reasoning that led to Reg. S was first expressed in 1986 by Quinn in her address to the American Bar Association's Federal Regulation of Securities Committee. She stated:

Perhaps it was appropriate before the Euromarket, London, Japan and [other markets] evolved . . . for the Commission to suggest that securities offered to a U.S. citizen anywhere in the world should comply with the Securities Act. . . . [But, as] investors may now choose their markets, so too should they have to accept the laws applicable to . . . such markets.

Id. (citations omitted) (quoting Linda Quinn, Redefining "Public Offering or Distribution" for Today, Address to Federal Regulation of Securities Committee Annual Fall Meeting, Washington, D.C. (Nov. 22, 1986), reprinted in SEC News Release (Nov. 22, 1986)); cf. Trachtman, *supra* note 2, at 295 (stating that protection of U.S. citizens purchasing securities abroad is unnecessary to carry out SEC's principle purpose).

75. Wolff, *supra* note 2, at 105-06 (noting focus of Reg. S on extent of contact with United States and whether "offer or sale occurs outside borders of United States"); cf. Trachtman, *supra* note 2, at 295 (clarifying that investors who buy securities outside United States effectively opt to forego protection of U.S. securities laws).

76. See *supra* note 65 and accompanying text (citing examples of SEC no-action letters); Wolff, *supra* note 2, at 116 (recognizing that SEC staff repeatedly expressed its view regarding themes that subsequently shaped Reg. S); see, e.g., INTERNATIONALIZATION REPORT, *supra* note 52, at I-1 (reporting on SEC staff's views); Wolff, *supra* note 2, at 113-14 (noting that Quinn speech stated SEC belief that investors should have to accept laws applicable to markets in which they choose to invest).

77. See *supra* note 29 and accompanying text (stating that doctrine of comity necessitates nation's tolerance and restraint in international affairs); see also Wolff, *supra* note 2, at 113-14 (expounding proposition that comity requires recognition of laws of other markets); Adopting Release, *supra* note 1, at 80,665 (recognizing that "[p]rinciples of comity and the reasonable expectations of participants in the global markets justify reliance on laws applicable in jurisdictions outside the United States to define requirements for transactions effected offshore"); Trachtman, *supra* note 2, at 294 (citing Adopting Release's justification for relying on foreign countries' laws to govern offshore transactions).

78. Trachtman, *supra* note 2, at 295 (distinguishing U.S. mutual recognition approach based on comity, from European Community approach based on single market program).

79. PESSIN & ROSS, *supra* note 25, at 618. Secondary financial markets, including both exchanges and over-the-counter markets, are markets where issued and outstanding securities are sold. *Id.* A primary market differs from a secondary market in that the primary market is the market for assets or new issues where the sale's proceeds go to the issuer, and the secondary market is the market for outstanding issues. *Id.* at 542, 618.

the periodic disclosure mandated by the 1934 Act.⁸⁰ Although many secondary market purchases occurred only moments after the securities were first offered offshore, prior to Regulation S, U.S. investors were unable to purchase in offshore primary offerings because of section 5's extraterritorial operation.⁸¹

Regulation S cleared the way for purchasing in primary offerings in certain cases, thereby allowing increased access to securities markets for both issuers and investors.⁸² At the same time, however, it appears to have cleared the way for "non-U.S." investors to take advantage of the safe harbor through activities such as short-selling.⁸³ The regulation was initially proposed for comment on June 10, 1988⁸⁴ and was revised and repropounded on July 11, 1989.⁸⁵ Because of the opportunity for comment provided by the SEC,⁸⁶ Regulation S as adopted on April 24, 1990⁸⁷ had already resolved many problems that commentators identified.⁸⁸ Unfortunately, until the Regulation was put to use and its practical effects understood, neither commentators nor the SEC could have predicted the abuses that have since resulted.

80. 15 U.S.C. § 78(a) (1994); *see also* Wolff, *supra* note 2, at 11 (articulating reporting system of 1934 Act as central basis for Reg. S (citing Quinn Speech)); Wolff, *supra* note 2, at 114 (crediting reliance on 1934 Act's periodic reporting system for investor protection as pivotal construct of Reg. S).

81. INTERNATIONALIZATION REPORT, *supra* note 52, at III-314; *see also* Wolff, *supra* note 2, at 114 (noting anomaly that U.S. investors could purchase freely in foreign secondary markets, although initially denied right to purchase in primary offshore offerings).

82. *See generally* Adopting Release, *supra* note 1, at 80,664-65 (lauding Reg. S for allowing increase in offshore offerings by issuers and expanded participation by U.S. investors in world securities markets).

83. *See infra* notes 288-329 and accompanying text (illustrating alleged abuses of Reg. S and recapitulating concept of short-selling).

84. Offshore Offers and Sales, Securities Act Release No. 33-6779, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,242, at 89,123 (June 10, 1988) [hereinafter Proposing Release].

85. Offshore Offers and Sales, Securities Act Release No. 33-6838, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,426, at 80,209 (July 11, 1989) [hereinafter Reproposing Release].

86. *See* Adopting Release, *supra* note 1, at 80,662 (inferring that SEC furnished ample opportunity for public comment on Reg. S). The SEC reports that 95 comment letters were received on the initial proposal and 44 comment letters were received on the reproposal. *Id.* at nn.3 & 5.

87. Adopting Release, *supra* note 1, at 80,662 & n.7 (recognizing substantive and organizational changes in rule adopted because of criticism). At the same time that the SEC adopted Reg. S, it also adopted Rule 144A, a rule which provides a registration exemption to certain resales of securities in the United States, if the seller is in compliance with specific conditions. Bradley, *supra* note 31, at 179; *see also infra* note 192 (summarizing provisions of Rule 144A and its legal effect).

88. *See* Adopting Release, *supra* note 1, at 80,662 (describing comments as strongly supportive and suggestive of modifications to increase utility of Reg. S); Silverman & Braverman, *supra* note 55, at 180 (lauding Reg. S as "marked improvement" over original proposal because problems were previously identified); *cf.* Gibbons, *supra* note 30, at 379-84 (proposing clarifications to Reg. S).

II. THE GENERAL STRUCTURE OF REGULATION S

Both Regulation S and Release 4708 set out standards intended to define the reach of section 5's registration requirements and provide exemptions therefrom.⁸⁹ Regulation S, however, sets different limits on acceptable behavior.⁹⁰ It interprets the extraterritorial reach of section 5 of the 1933 Act by espousing a territorial approach in outlining the scope of the registration requirements.⁹¹ The general precept is that these registration requirements do not pertain to offers and sales made outside the United States.⁹² In other words, only if the transaction occurs within the United States must it be registered with the SEC.

As a series of formally adopted SEC rules,⁹³ Regulation S also protects from liability those persons relying on it in good faith.⁹⁴ Because Regulation S is an agency rule adopted pursuant to the provisions of the Administrative Procedure Act⁹⁵ and section 19(a) of the 1933 Act,⁹⁶ it is binding authority.⁹⁷ This authority differs

89. See Adopting Release, *supra* note 1, at 80,665 (explaining territorial approach to limiting application of § 5 registration requirement); Release 4708, *supra* note 54, at 1362 (setting out standards to define reach of 1933 Act's registration requirements and providing exemption therefrom).

90. Wolff, *supra* note 2, at 117 (noting difference between Reg. S and Release 4708 only in manner of defining boundaries of acceptable conduct). See generally Adopting Release, *supra* note 1, at 80,665 (elaborating on boundaries of conduct under Reg. S); Release 4708, *supra* note 54, at 1361 (elaborating on boundaries of acceptable behavior under Release 4708).

91. See Gibbons, *supra* note 30, at 365 (asserting that Reg. S is based on territorial approach); see also Trachtman, *supra* note 2, at 295 (espousing Reg. S's territorial application of § 5); Wolff, *supra* note 2, at 117 (arguing that General Statement of Reg. S is based on territorial approach).

92. Gibbons, *supra* note 30, at 365; see also Bradley, *supra* note 31, at 186 (stating that transactions occurring outside United States need not be registered under § 5). The SEC implemented Reg. S, a territorial restraint on registration requirements, by defining offshore offers and sales outside of § 5 because the SEC lacked the exemptive authority under § 5 to do so. Coogan & Kimbrough, *supra* note 24, at 4. For the purposes of the § 5 registration provisions only, Reg. S is but a comprehensive definition of "offer," "offer to sell," "sell," "sale," and "offer to buy." *Id.* For purposes of § 5, the General Statement of Reg. S maintains that these terms exclude offers and sales made outside the United States thus creating safe harbors. *Id.*

93. Reg. S, *supra* note 1. Reg. S is comprised of Rules 901-904. See generally *id.* §§ 230.901-.904 (listing series of rules).

94. Securities Act of 1933, 15 U.S.C. § 77s(a) (1994) (directing that "no provision of this subchapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission"); see *Transnational Aspects*, *supra* note 27, at 5-18 (citing § 19(a) of 1933 Act, 15 U.S.C. § 77s(a) (1994)); see also Wolff, *supra* note 2, at 117 (emphasizing that Reg. S's adoption pursuant to § 19(a) of 1933 Act removes any doubt that may have existed under Release 4708 about whether persons relying on exemption in good faith are protected from liability).

95. 5 U.S.C. § 553 (1994).

96. 15 U.S.C. § 77s(a) (1994).

97. *Id.* Section 19(a) is specific statutory authority that makes the related rules and regulations binding; cf. Wolff, *supra* note 2, at 124 n.152 (questioning whether private litigants

significantly from Release 4708, which was merely a no-action position taken by the SEC.⁹⁸

A. Operative Definitions

Regulation S can be distinguished from Release 4708 by its operative definitions. For example, while both Release 4708 and Regulation S are territorial in nature,⁹⁹ Regulation S's territorial approach differs significantly from its predecessor in the manner in which it defines "U.S. person."¹⁰⁰

1. "U.S. person"

Regulation S imposes a primary constraint on sales to "U.S. persons"¹⁰¹ during the restricted period.¹⁰² The definition of "U.S. person" adopted in Regulation S is the fundamental basis for its territorial operation.¹⁰³ In testing a natural person's status as a "U.S. person" for the purposes of Reg. S, U.S. *residency*, rather than U.S. citizenship, is the standard.¹⁰⁴ Accordingly, a person who is a

are bound by SEC's interpretation of registration requirements in absence of official rules or regulations).

98. See Wolff, *supra* note 2, at 124 n.152 (raising doubt that Commission's previous no-action interpretation of registration requirements was binding, even though Commission has sole authority to decide which enforcement actions to pursue as a matter of prosecutorial discretion).

99. Gibbons, *supra* note 30, at 365. Both Reg. S and Release 4708 exempt transactions that occur abroad from the § 5 registration requirements. *Id.*

100. Gibbons, *supra* note 30, at 365. For the purposes of Release 4708, a "U.S. person" included any American citizen, even those living abroad. Release 4708, *supra* note 54, ¶ 1362. Reg. S, however, excludes from the definition of "U.S. person" any U.S. citizen not residing in the United States. Adopting Release, *supra* note 1, at 80,676; see also *infra* notes 103-10 and accompanying text (elaborating on definition of "U.S. person" and its utility).

101. See Wolff, *supra* note 2, at 129 (calling definition of "U.S. person" critical element of Reg. S safe harbors).

102. See Reg. S, *supra* note 1, § 230.902(m). Reg. S defines "restricted period" as the period that begins either on the date of the offering's closing or the date upon which the Reg. S securities were first offered to people other than distributors, whichever is later. *Id.* Distributor's sales of unsold allotments are considered to be made during the restricted period. *Id.* Further, the restricted period for continuous offerings commences upon the distribution's completion. *Id.*; see also Wolff, *supra* note 2, at 129 (calling definition of "U.S. person" critical element of Reg. S safe harbors).

103. See Wolff, *supra* note 2, at 118 (observing that Reg. S's territorial theory is "both reflected in and tested by the Regulation's definition of 'U.S. person'").

104. Adopting Release, *supra* note 1, at 80,676; see Reg. S, *supra* note 1, § 230.902(o)(1)(i) (construing "U.S. person" as "any natural person resident in the United States"); see also Wolff, *supra* note 2, at 118 (stating that residency is touchstone in determining whether natural person will be treated as "U.S. person"). Exceptions to the definition of U.S. person include: any agency or branch of a U.S. person located outside the United States and operating for valid business reasons, involved in the banking or insurance business, and regulated as such in the jurisdiction where it is located; and any discretionary account held by a professional fiduciary or dealer in the United States for the benefit of a non-U.S. person. Wolff, *supra* note 2, at 130. Transient visitors to the United States are not considered U.S. persons, but transactions with them are considered to occur in the United States and, therefore, cannot be done pursuant to

U.S. citizen but who does not reside in the United States is not considered a "U.S. person" under Regulation S. A person residing in the United States, however, regardless of citizenship, is a "U.S. person." For example, a British citizen living in the United States is considered a U.S. person for purposes of Regulation S's application while a U.S. citizen living in Britain is not. This approach focuses on the geographical location of the investor¹⁰⁵ and is consistent with the theory that section 5 protects persons purchasing in the U.S. capital market and leaves enforcement against, and protection of, U.S. persons living abroad to the discretion of other countries' securities laws.¹⁰⁶

Regulation S also treats a trust or estate as a U.S. person if any trustee, executor, or administrator is a "U.S. person."¹⁰⁷ With respect to U.S. fiduciaries, however, the Regulation as adopted treats U.S. professional fiduciaries acting with discretion for non-U.S. persons as "non-U.S. persons."¹⁰⁸ Moreover, a corporation's place of incorporation determines whether it is a U.S. person for the purposes of Regulation S.¹⁰⁹ The exception to this definition is that a corporation incorporated under foreign law is still considered a "U.S. person" if it is formed by a U.S. resident for the sole purpose of investing in unregistered securities,¹¹⁰ unless incorporated and owned by "accredited investors."¹¹¹

Reg. S. *Id.* at 130-31.

105. Wolff, *supra* note 2, at 118 (focusing on geographical location of investor).

106. See Wolff, *supra* note 2, at 113-14 (enunciating sentiment that investors choosing to invest in foreign markets should be subject to laws applicable to those markets (citing Quinn Speech)). The necessity for comity was recognized as early as 1972 when Chief Justice Burger proclaimed that it was inappropriate for the United States to "insist on a parochial concept that all disputes must be resolved under [U.S.] laws and in [U.S.] courts We cannot have trade and commerce in world markets and international waters exclusively on our terms, governed by our laws, and resolved in our courts." *Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 8 (1972).

107. Reg. S, *supra* note 1, § 230.902(o)(1)(iii)-(iv); see also Wolff, *supra* note 2, at 118 (stating general rule regarding trusts and estates as U.S. persons).

108. Reg. S, *supra* note 1, § 230.902(o)(1)(vi)-(vii). This definition was amended in response to critics' concern for its competitive effects on U.S. professional fiduciaries. Adopting Release, *supra* note 1, at 80,676; see also Wolff, *supra* note 2, at 118 (recounting treatment of U.S. fiduciaries under Reg. S before current treatment was adopted).

109. See Reg. S, *supra* note 1, §§ 230.902(o)(1)(ii), (viii)(A)-(B) (determining when corporation is treated as "U.S. person"). Generally, a corporation incorporated under U.S. laws is a "U.S. person" and a corporation incorporated under foreign law is not. *Id.*; see Wolff, *supra* note 2, at 119 (evaluating residency of corporations under Reg. S).

110. Reg. S, *supra* note 1, § 230.902(o)(1)(viii)(A)-(B); see also Wolff, *supra* note 2, at 118-19 (discussing exception to corporation's residency requirement).

111. Reg. S, *supra* note 1, § 230.902(o)(1)(viii)(B). "Accredited investors" is defined in Regulation D—Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. § 230.501(a) (1995). *Id.* Such investors cannot be natural persons, trusts, or estates. *Id.*; see also *Transnational Aspects*, *supra* note 27, §§ 5-20 to 5-21 (summarizing Regulation D provision as providing that corporations formed for purpose of acquiring unregistered securities are not accredited investors); Wolff, *supra* note 2, at 119

2. *Other definitions*

Providing a detailed analysis of all of the definitions contained in Regulation S is beyond the scope of this Comment.¹¹² To understand Regulation S and its method of categorizing securities, however, requires a familiarity with some of the fundamental definitions, beyond that of "U.S. person." Rule 902 defines several terms¹¹³ to which the SEC refers frequently throughout the various categories of the Regulation S safe harbor provisions.¹¹⁴ Although these terms are not used in the General Statement,¹¹⁵ they are helpful in construing it.¹¹⁶

Regulation S categorizes transactions on the basis of characteristics such as nationality of the securities issuer, reporting status of the issuer, and the extent of U.S. market interest in the securities.¹¹⁷ These factors reasonably reflect the amount of available information regarding such securities,¹¹⁸ as well as the likelihood that the securities will flow back into the United States.¹¹⁹

The likelihood that securities from a Regulation S offering will flow into the United States following an offshore distribution is of fundamental concern to the SEC.¹²⁰ The Regulation S Proposing Release¹²¹ enumerated the likelihood of flowback, or the likelihood that the securities will not come to rest abroad, as a factor in determining whether or not a transaction actually occurred outside

(noting that corporations formed by accredited investors are exception to U.S. corporation definition).

112. See generally Reg. S, *supra* note 1, § 230.902 (setting forth all definitions relating to Reg. S).

113. Reg. S, *supra* note 1, § 230.902.

114. Reg. S, *supra* note 1, §§ 230.903-904; see *supra* note 24 (proffering Reg. S's two safe harbor provisions: issuer and resale).

115. Reg. S, *supra* note 1, § 230.901; see also *supra* notes 165-72 and accompanying text (elaborating on application and utility of General Statement).

116. See Wolff, *supra* note 2, at 128 (recognizing that definitions apply equally to both safe harbors and General Statement).

117. Adopting Release, *supra* note 1, at 80,671 (distinguishing three classes of securities based on specific criteria); see also Wolff, *supra* note 2, at 131 (categorizing transactions based on certain variables).

118. Adopting Release, *supra* note 1, at 80,671 (noting that criteria were chosen because they reflect two important concerns: likelihood of flowback into United States and amount of available information).

119. Adopting Release, *supra* note 1, at 80,671; see also Wolff, *supra* note 2, at 131 (noting that Commission believed less flowback occurs when there is no pre-existing U.S. market interest in issuer's securities).

120. See Adopting Release, *supra* note 1, at 80,675 (alluding to likelihood of flowback as thwarting SEC intention to protect U.S. markets and investors by requiring registration of securities).

121. Proposing Release, *supra* note 84, at 89,123.

the United States, and hence outside the scope of section 5.¹²² While such factors are not included in Reg. S as adopted,¹²³ the possibility that securities will enter the United States after an offshore offering remains a significant concern and is repeatedly referred to in the adopted Regulation.¹²⁴ The SEC's paramount goal is to provide protection to U.S. investors.¹²⁵ To achieve this end, the SEC mandates some form of public disclosure from securities issuers.¹²⁶ This goal will be thwarted, however, if securities offered pursuant to Regulation S flow into the United States while there is little or no publicly available information regarding the issuer.

Categorization of the Regulation S issuer safe harbor is a crucial element of the regulatory scheme because it controls the type of restrictions imposed upon the offer and sale of different securities.¹²⁷ Accordingly, Regulation S's issuer safe harbor is comprised of three categories of securities, each subject to different restrictions.¹²⁸ For issuers in Category 1,¹²⁹ the tendency toward flowback is not troublesome because the issuers are reporting issuers under the 1934 Act.¹³⁰ There is, therefore, sufficient information about the issuer available in the marketplace to ensure investor protection. Category 2¹³¹ issuers, however, include some non-

122. Proposing Release, *supra* note 84, at 89,132 (specifying likelihood of securities coming to rest abroad as factor to consider in determining whether transaction occurs outside United States).

123. See Adopting Release, *supra* note 1, at 80,666 (eliminating, upon recommendation of commentators, list of factors for determining whether an offer or sale occurred outside United States).

124. Adopting Release, *supra* note 1, at 80,671-72 (presenting examples of Commission's repeated references to concern about flowback).

125. See Michael Schroeder, *At the SEC, a Deft Crusader for Reform*, BUS. WK., Feb. 20, 1995, at 72-73 (describing current SEC Chairman Arthur Levitt's mandate to protect investors); *supra* notes 61, 261 and accompanying text (referring to SEC's intention of preventing flowback).

126. Securities Act of 1933, § 5, 15 U.S.C. § 77e (1994); see also Securities Act of 1934, 15 U.S.C. § 78(a) (1994) (setting out disclosure requirements). The extent of required disclosure differs depending upon the status of the issuer. Reg. S, *supra* note 1, § 230.903.

127. See Wolff, *supra* note 2, at 131 (emphasizing "critical importance" of categorization in determining nature and extent of restrictions).

128. Reg. S, *supra* note 1, § 230.903 (listing three categories of securities in issuer safe harbor and their applicable restrictions); see also *infra* notes 199-270 and accompanying text (differentiating among categories of securities on basis of associated risk).

129. Reg. S, *supra* note 1, § 230.903(c)(2); see also *supra* notes 202-11 and accompanying text (providing further explanation of Category 1 securities).

130. Reg. S, *supra* note 1, § 230.902(l). Rule 902(l) defines "reporting issuer" as an issuer, other than an investment company required to register under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 to 80a-64 (1994) that registers securities under or is required to file reports pursuant to the 1934 Act, and has filed such required materials for at least the twelve months prior to the Reg. S transaction. *Id.*

131. Reg. S, *supra* note 1, § 230.903(c)(2); see also *infra* notes 212-43 and accompanying text (expanding upon description of Category 2 securities and corresponding requirements necessary to qualify for safe harbor).

reporting issuers, and Category 3¹³² issuers are all non-reporting issuers.¹³³ Accordingly, there is little information about these issuers publicly available to American investors and, thus, the prospect that non-reporting issuers' securities may flow into the United States after the offshore offering is increasingly distressful. Short-selling, which is one way that unregistered securities migrate into the United States after an offshore offering, virtually guarantees that Category 3 securities will flow back into the United States.¹³⁴

One factor relevant in determining the category to which an issuer belongs is the existence, or lack thereof, of a "substantial U.S. market interest" (SUSMI) in an issuer's securities.¹³⁵ The SEC's justification for using SUSMI as a criterion is that there is a "lesser probability of flowback [of unregistered securities into the United States] where there is no pre-existing U.S. market interest for the securities of a foreign issuer."¹³⁶ Rule 902(n) applies different definitions of SUSMI to equity and to debt securities.¹³⁷ SUSMI exists for equity securities if an issuer satisfies at least one of two requirements, each based upon the degree of securities trading occurring in the United States.¹³⁸ The first test indicating that SUSMI for equity securities exists is that the U.S. market for the security¹³⁹ comprised the single largest market for that class of securities in the issuer's preceding

132. Reg. S, *supra* note 1, § 230.903(c)(3); *see also infra* notes 244-70 and accompanying text (describing residual safe harbor category and its stringent requirements).

133. Reg. S, *supra* note 1, § 230.903(c)(3); *cf. id.* § 230.902(l) (designating reporting issuers as those that register or are required to register under 1940 Act and specifying additional requirements).

134. *See infra* notes 306-23 and accompanying text (detailing process of short-selling). When an investor sells short with Reg. S stock, the investor must wait only the length of the restricted period before the investor can cover (replace the borrowed stock). *See* Cohen, *supra* note 4, at C1 (noting that investors need only wait 40 days before replacing borrowed shares with Reg. S stock). Short-selling with the Reg. S security seems to create a U.S. market interest in the security because the short-seller is relying on the Reg. S security to cover for the security sold short. Accordingly, the security is not really coming to rest abroad, by virtue of the demand for the security on the part of U.S. investors. This demand increases the likelihood that the security that is sold abroad pursuant to Reg. S will flow back into the United States. Consequently, it is doubtful that this security will come to rest abroad. Proposing Release, *supra* note 84, at 89, 123-89, 133.

135. Reg. S, *supra* note 1, § 230.902(n). SUSMI is of particular importance for purposes of Reg. S because it is necessary to determine which safe harbor category an issuer can utilize: the less SUSMI, the fewer applicable restrictions. *Id.* § 230.903.

136. Proposing Release, *supra* note 84, at 89, 136; *cf. id.* at 89, 125 (noting that sales and resales abroad are permitted pursuant to Release 4708 where issuers had no "active market" for securities in United States).

137. *See* Reg. S, *supra* note 1, § 230.902(n)(1)-(2) (defining SUSMI with respect to equity and debt securities).

138. Reg. S, *supra* note 1, § 230.902(n)(1)(i)-(ii); *see also* Wolff, *supra* note 2, at 131 (stating two tests of equity securities' SUSMI are based on extent of securities trading in United States).

139. Reg. S, *supra* note 1, § 230.902(n)(1)(i). The U.S. market includes the inter-dealer quotation systems and securities exchanges. *Id.*

fiscal year.¹⁴⁰ Alternatively, SUSMI exists if at least twenty percent of all trading in the equity securities occurred in the U.S. market¹⁴¹ and less than fifty-five percent of the trading occurred "in, on, or through" a single foreign country's securities markets during the preceding fiscal year.¹⁴²

In the case of a debt securities offering, there is a SUSMI if an issuer satisfies three requirements regarding the amount or proportion of debt held of record by U.S. persons:¹⁴³ (1) all debt securities and non-convertible capital stock not entitled to participate in residual earnings or assets of the issuer¹⁴⁴ or certain asset-backed securities¹⁴⁵ are held of record by at least 300 U.S. persons;¹⁴⁶ (2) one billion dollars or more in principal amount of all debt securities¹⁴⁷ in the aggregate is held of record by U.S. persons;¹⁴⁸ and (3) twenty percent or more in principal amount of all debt securities is held of record by U.S. persons.¹⁴⁹

Defining an "overseas directed offering" (ODO)¹⁵⁰ is also important to understanding the issuer safe harbor categories of Regulation S. ODOs are given favorable treatment in the issuer safe harbor because their potential for flowback into the United States is modest.¹⁵¹ An ODO is either: (1) a foreign issuer's securities offering directed to the residents of a single country (other than the United States), offered in that country, and made in accordance with that country's local laws, customary practices, and documentation;¹⁵² or (2) an offering of a domestic issuer's¹⁵³ non-convertible debt

140. Reg. S, *supra* note 1, § 230.902(n)(1)(i). This test permits the U.S. market to constitute the issuer's single largest market either during the previous fiscal year or since the issuer's incorporation, whichever is shorter. *Id.*

141. Reg. S, *supra* note 1, § 230.902 (n)(1)(i) (delineating U.S. market).

142. Reg. S, *supra* note 1, § 230.902(n)(1)(ii).

143. Reg. S, *supra* note 1, § 230.902(n)(2)(i)-(iii); see also Wolff, *supra* note 2, at 131.

144. See Reg. S, *supra* note 1, § 230.903(c)(4)(i)-(ii) (describing securities encompassed as debt securities).

145. Reg. S, *supra* note 1, § 230.903(c)(4)(i)-(ii). Asset-backed securities are securities "whose underlying collateral or cash flow is dependent on an item of value . . . [like] . . . receivables of corporations." PESSIN & ROSS, *supra* note 25, at 34.

146. Reg. S, *supra* note 1, § 230.902(n)(2)(i).

147. Reg. S, *supra* note 1, § 230.902(n)(2)(ii).

148. Reg. S, *supra* note 1, § 230.902(n)(2)(ii).

149. Reg. S, *supra* note 1, § 230.902(n)(2)(iii).

150. Reg. S, *supra* note 1, § 230.902(j).

151. See Adopting Release, *supra* note 1, at 80,672, 80,674 (stating that flowback concerns are limited where offering of foreign issuer's securities is directed at non-U.S. market); see also Wolff, *supra* note 2, at 132 (terming ODOs as transactions that are given favorable treatment).

152. Reg. S, *supra* note 1, § 230.902(j)(1). For example, if issuer A is a British company conducting a securities offering directed at the residents of Britain, this offering would constitute an ODO. *Id.*

153. Reg. S, *supra* note 1, § 230.902(d). A domestic issuer is defined in Rule 902(d) as "any issuer other than a foreign issuer." *Id.*; cf. *id.* § 230.902(f) (designating foreign governments,

securities¹⁵⁴ directed to the residents of a single country (other than the United States) in that country and made in accordance with the local laws, customary practices, and documentation of the country, provided that the principal and interest of the securities are denominated in foreign currency and are not convertible into U.S. dollar-denominated securities or otherwise linked to U.S. dollars.¹⁵⁵ An offering will not qualify as an ODO if an issuer, distributor, or affiliate knows or should have known that a substantial part of the offering will be sold or resold outside the country in which it occurs.¹⁵⁶ If an issuer or distributor knows or should have known that the offering would be sold or resold outside that country or in the United States, even though the offering is in technical compliance with Reg. S, it contravenes both the objectives of the Regulation and the policies underlying the 1933 Act.¹⁵⁷ Such an issuer cannot rely on the Regulation S safe harbor.¹⁵⁸

The definition of "distributor" includes any dealer, underwriter, or other person participating in the distribution of Reg. S securities pursuant to a contractual agreement.¹⁵⁹ Such distributors, in addition to the issuer, and the affiliates and agents of either, are subject to limitations during restricted periods imposed by the issuer safe harbor.¹⁶⁰ Such a "restricted period" begins either on the date of the offering's closing or the date on which the securities were initially offered to persons other than distributors in reliance on

nationals of foreign countries, and corporations organized under foreign countries' laws as foreign issuers). In contrast to the example mentioned in note 152, *supra*, if a U.S. issuer conducts an offering of non-convertible debt securities directed towards the residents of Britain then it is deemed an ODO, as long as the issuer complies with the laws of Britain and the principal and interest are in a foreign currency and are not convertible into or linked to U.S. dollars. *Id.* § 230.902(j)(2).

154. See Reg. S, *supra* note 1, § 230.903(c)(4)(i), (ii) (defining holders of non-convertible capital stock as entitled to preference in payment of dividends and asset distribution, but not to participation in residual earnings or assets of issuer).

155. See Reg. S, *supra* note 1, § 230.902(j)(2).

156. See Adopting Release, *supra* note 1, at 80,674 & n.99 (citing Preliminary Note 2 to Reg. S).

157. Reg. S, *supra* note 1, at Preliminary Note 2 to §§ 230.901-904. Preliminary Note 2 provides that, in light of the rules' objectives, "Regulation S is not available with respect to any transaction or series of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the [1933] Act." *Id.*

158. Reg. S, *supra* note 1, at Preliminary Note 2 to §§ 230.901-904.

159. Reg. S, *supra* note 1, § 230.902(c). Requiring the distributor to participate pursuant to a contract enables statutory underwriters, as defined in the Securities Act of 1933, 15 U.S.C. § 77(b)(11) (1994), who are not distributors and who do not participate pursuant to a contractual arrangement, to benefit from the separate resale safe harbor embodied in Rule 904, *infra* notes 271-85, rather than having to rely on the more restrictive distributor resale provision in Rule 903. Wolff, *supra* note 2, at 128.

160. See, e.g., Reg. S, *supra* note 1, § 230.903(c)(2)(iii)-(iv) (imposing 40-day restricted periods).

Regulation S, whichever is later.¹⁶¹ The period expires at a time specified in the Regulation.¹⁶² The "restricted period" definition further provides that all offers and sales of unsold allotments or subscriptions by a distributor are considered to be made during the restricted period.¹⁶³ Furthermore, Regulation S provides that the term "restricted period" also applies to continuous offerings.¹⁶⁴

B. General Statement (Non-Safe Harbor Approach)

Rule 901 is a general statement (General Statement) of the applicability of section 5's registration provisions, and it is the rule that links Regulation S to section 5 of the 1933 Act.¹⁶⁵ The General Statement provides that any "offer," "offer to sell," "sale," or "offer to buy" is subject to section 5 if it occurs within the United States.¹⁶⁶ Conversely, if a transaction is to qualify for exemption from registration under the General Statement, both the offer and sale must be made "outside the United States."¹⁶⁷ Any transaction deemed, on its face,¹⁶⁸ to occur outside the United States is exempt from the registration requirements of the 1933 Act, regardless of whether or not the conditions of the safe harbor are met.¹⁶⁹ Offers and sales, therefore, may proceed without registration based solely on the General Statement.¹⁷⁰

161. Reg. S, *supra* note 1, § 230.902(m).

162. Reg. S, *supra* note 1, § 230.902(m).

163. Reg. S, *supra* note 1, § 230.902(m).

164. Reg. S, *supra* note 1, § 230.902(m). This includes continuous offerings of non-convertible debt securities offered and sold in trenches, and securities to be seized upon the exercise of warrants. *Id.*; see also Wolff, *supra* note 2, at 129 (identifying special provision for application of "restricted period" to continuous offerings).

165. Reg. S, *supra* note 1, § 230.901; see also Adopting Release, *supra* note 1, at 80,665 (elaborating on General Statement provision); *Transnational Aspects*, *supra* note 27, at 5-18 (stating that General Statement is operative linking provision); Wolff, *supra* note 2, at 126 (providing that Rule 901 is Reg. S's operative link to § 5).

166. Reg. S, *supra* note 1, § 230.901; see Wolff, *supra* note 2, at 126 (determining that offers and sales within United States are included in § 5).

167. Adopting Release, *supra* note 1, at 80,665. For example, A makes an offer of securities to B while A is outside the United States and B accepts. If the actual sale from A to B occurs while both A and B are outside the United States, then the securities are not subject to the § 5 registration requirements. In this instance, it is irrelevant that B may in fact be buying the Reg. S securities on behalf of a U.S. person.

168. Adopting Release, *supra* note 1, at 80,665. Whether a transaction occurs outside the United States is determined by the facts and circumstances of each case. *Id.*

169. Adopting Release, *supra* note 1, at 80,665; see also Wolff, *supra* note 2, at 126 (delineating transactions "outside the United States" within meaning of General Statement).

170. Coogan & Kimbrough, *supra* note 24, at 4. As adopted, Reg. S eliminated four relevant considerations, contained in the proposing release, for use in determining when a transaction occurred outside the United States. *Id.* These considerations included the location of the component elements of the offer or sale, the absence of directed selling efforts in the United States, the likelihood of the securities coming to rest abroad, and the parties' justified expectations concerning the applicability of § 5. Proposing Release, *supra* note 84, at 89,130-

Until a body of administrative law develops under Rule 901, however, it is probably unwise to rely on the General Statement when structuring a transaction.¹⁷¹ Rule 901 is perhaps most useful as a basis for arguing that a transaction occurred outside the United States, in the event that an offering designed to comply with a safe harbor fails to do so.¹⁷²

C. General Conditions for Rule 903 and 904 Safe Harbors

Regulation S creates different safe harbors for the offshore distribution and resale of securities.¹⁷³ Rule 903, the issuer safe harbor provision, regulates offers and sales by issuers, distributors, and their affiliates and agents.¹⁷⁴ Rule 904, the resale safe harbor, regulates resales of Reg. S shares.¹⁷⁵ There are two primary requirements that must be satisfied in order for either safe harbor to apply.¹⁷⁶ First, offers and sales must be made in an "offshore transaction."¹⁷⁷ Second, there must be no "directed selling efforts" in the United States in connection with these offers and sales.¹⁷⁸

As defined in Rule 902(i),¹⁷⁹ an "offshore transaction" is one in which an offer is made to a person who is outside the United

89,133. Commentors suggested that such factors were unhelpful and, consequently, they were deleted from the Regulation. See Adopting Release, *supra* note 1, at 80,666 (explaining reasons for deletion of four factors); Wolff, *supra* note 2, at 127 (listing Proposing Release's relevant considerations); see also *Transnational Aspects*, *supra* note 27, § 5-19 (noting factors for determining location of transaction).

171. See Wolff, *supra* note 2, at 128 (predicting that eventually body of case law will develop to clarify Rule 901).

172. See Wolff, *supra* note 2, at 128 (using Rule 901 to argue in litigation that particular transaction was outside United States); see also Coogan & Kimbrough, *supra* note 24, at 4 (suggesting General Statement is most important as backstop).

173. See Wolff, *supra* note 2, at 132 (recognizing two distinct safe harbors established by Reg. S).

174. Reg. S, *supra* note 1, § 230.903.

175. Reg. S, *supra* note 1, § 230.904; see also Wolff, *supra* note 2, at 132 (discussing Reg. S's separate safe harbors).

176. Adopting Release, *supra* note 1, at 80,666; see, e.g., Bradley, *supra* note 31, at 186 (stating that Reg. S requires compliance with two general conditions); Coogan & Kimbrough, *supra* note 24, at 4 (outlining requirements of general conditions for safe harbors); Silverman & Braverman, *supra* note 55, at 180-81 (noting that Reg. S consists of two safe harbors with two general conditions); Wolff, *supra* note 2, at 132 (recalling that there are two general conditions to satisfy).

177. Reg. S, *supra* note 1, § 230.903(a).

178. Reg. S, *supra* note 1, § 230.903(b).

179. Reg. S, *supra* note 1, § 230.902(i). Rule 902(i) provides a few variations to the definition of an offshore transaction. For example, offshore transactions do not include offers and sales specifically targeted at identifiable groups of U.S. citizens abroad, such as members of the armed forces. *Id.* § 230.902(i)(2). Offers and sales to certain international organizations and professional fiduciaries acting on behalf of non-U.S. persons, however, are offshore transactions. *Id.* § 230.902(i)(3).

States¹⁸⁰ and either (1) the buyer is, or is reasonably believed by the seller to be, outside the United States when the order originates,¹⁸¹ or (2) the transaction is executed on the trading floor of an established foreign securities exchange¹⁸² or through a designated offshore securities market (DOSM),¹⁸³ provided that the seller does not know the transaction has been pre-arranged with a U.S. buyer.¹⁸⁴ The meaning of "offshore transactions" itself, however, provides a vehicle for potential abuses of Regulation S because a transaction's occurrence offshore is contingent upon the extent of the seller's knowledge about the buyer's location.

The second general condition, the prohibition against "directed selling efforts,"¹⁸⁵ is defined in Rule 902(b).¹⁸⁶ Directed selling efforts are any activities undertaken for the purpose of "conditioning"¹⁸⁷ the U.S. market for securities being offered, or any activity that could reasonably be expected to do so.¹⁸⁸ Marketing efforts designed and subsequently expected to stimulate U.S. interest in the securities being offered abroad are therefore prohibited.¹⁸⁹ Pro-

180. Reg. S, *supra* note 1, § 230.902(i)(1)(i); cf. *supra* notes 103-11 and accompanying text (explicating meaning and use of "U.S. person").

181. Reg. S, *supra* note 1, § 230.902(i)(1)(ii)(A). In light of today's electronic age, it is exceedingly difficult to pinpoint where many transactions actually take place. Wolff, *supra* note 2, at 120 (quoting former SEC Commissioner Richard Smith); see also Coogan & Kimbrough, *supra* note 24, at 4 (reiterating SEC's view that safe harbors must require objective criteria even if global electronic trading inhibits answering questions about where some transactions occur).

182. Reg. S, *supra* note 1, § 230.902(i)(1)(ii)(B)(1) (listing condition for resales).

183. Reg. S, *supra* note 1, § 230.902(i)(1)(ii)(B)(2). DOSMs include the Eurobond market, as regulated by the Association of International Bond Dealers; certain overseas stock exchanges specified in the rule; and any foreign securities exchange or non-exchange market designated by the SEC. *Id.* § 230.902(a)(1), (2). For examples of DOSMs subsequently designated by the SEC, see First Boston Corp., SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,462, at 77,380 (June 14, 1990) (U.K. Stock Exchange Automated Quotation International System); Shearson Lehman Hutton, Inc., SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,498, at 77,533 (July 7, 1990) (Helsinki Stock Exchange).

184. Reg. S, *supra* note 1, § 230.902(i)(1)(ii)(B)(2). The offshore transaction requirement can cause problems. For example, A sells Reg. S securities to B, who is located in the Cayman Islands. B, however, is not the ultimate buyer of the securities. B is actually buying for the benefit of C, who is in the United States, and A has reason to believe this. The seller, therefore, should always be aware of Preliminary Note 2 to Reg. S. Wolff, *supra* note 2, at 133 n.202; see also *supra* note 157 (quoting Preliminary Note 2 to Reg. S).

185. Reg. S, *supra* note 1, § 230.903(b).

186. Reg. S, *supra* note 1, § 230.902(b).

187. Adopting Release, *supra* note 1, at 80,668-69. Conditioning the U.S. market occurs when an issuer undertakes marketing efforts in the United States intended to induce purchasers to buy securities being distributed abroad. *Id.* at 80,668. Such marketing efforts include conducting promotional seminars, placing advertisements with radio or television stations or in publications with circulation in the United States, and mailing printed material to potential U.S. investors. *Id.*

188. Reg. S, *supra* note 1, § 230.902(b)(1) (defining directed selling efforts).

189. See Wolff, *supra* note 2, at 134 (prohibiting marketing efforts in United States designed to induce purchase of securities offered abroad); see also Trachtman, *supra* note 2, at 297 (defining directed selling efforts). This provision stems from the Commission's concern that

scribed "directed selling efforts" include conducting promotional seminars in the United States, mailing printed materials to U.S. investors, and advertising in publications with a general circulation in the United States.¹⁹⁰ Rule 902(b), however, specifically provides exceptions to the definition of directed selling efforts.¹⁹¹ For example, marketing efforts in connection with the sale of securities in a private placement or Rule 144A¹⁹² restricted stock transaction are not usually treated as directed selling efforts for the purposes of Regulation S.¹⁹³

D. Issuer-Distributor Safe Harbor

Rule 903 is the Regulation S safe harbor that regulates offers and sales by issuers, distributors, and their affiliates and agents.¹⁹⁴ It

publicity may "condition the public mind or arouse public interest in the security," Securities Act Release No. 33-3884 [Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 3254, at 3149 (Oct. 8, 1957), or "stimulate an appetite . . . for the securities." Carl M. Loeb Rhoades & Co., 383 SEC 843, 850 (1959), *cited in Transnational Aspects*, *supra* note 27, at 5-29.

190. Adopting Release, *supra* note 1, at 80,670. A publication with a general circulation in the United States is one printed essentially for distribution in the United States or which has had an average U.S. circulation of 15,000 copies or more within the past 12 months. Reg. S, *supra* note 1, § 230.902(k)(1)(i), (ii); see Silverman & Braverman, *supra* note 55, at 181 (listing actions constituting directed selling efforts); *Transnational Aspects*, *supra* note 27, at 5-29 (enumerating examples of directed selling efforts).

191. Reg. S, *supra* note 1, § 230.902(b)(2)-(4). Exceptions to directed selling efforts include: publication of an advertisement required by U.S. or foreign law; legitimate selling efforts in the United States in connection with a registered or an exempt transaction; a bona fide investigation of investment opportunities located within the United States; isolated, limited contact with the United States; routine activities conducted in the United States, like routine advertising and corporate communications; and the flow of normal corporation news. Adopting Release, *supra* note 1, at 80,669-70.

192. Resale of Restricted Securities, Securities Act Release No. 33-6862, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,523, at 80,637 (Apr. 23, 1990) [hereinafter Rule 144A Adopting Release]; see also Private Resales of Securities to Institutions, 17 C.F.R. § 230.144A (1994) [hereinafter Rule 144A]. While a detailed discussion of Rule 144A is beyond the scope of this Comment, it is important to recognize that the Rule's legal effect is substantially similar to that of Reg. S. Wolff, *supra* note 2, at 104 n.16. Rule 144A establishes a safe harbor from the 1933 Act's registration requirements for the resale of restricted securities to "qualified institutional buyers" (entities that owned and invested, on a discretionary basis, at least \$100 million in securities of unaffiliated issuers at the end of the entity's most recent fiscal year). Rule 144A, *supra*, § 230.144A(a). In creating such a safe harbor, Rule 144A liberalizes the rules governing the resale of privately placed securities in the United States. *Id.* In addition to the requirement that the resale be made only to qualified institutional buyers, there is a second requirement that the restricted security not be of the same class as securities listed on a U.S. stock exchange or quoted in a U.S. automated inter-dealer quotation system like NASDAQ. Rule 144A, *supra*, § 230.144A(d)(3)(i). If the issuer is neither a reporting company filing pursuant to 17 C.F.R. § 240.12g3-2(b) nor a foreign government, the security holder and a prospective purchaser have the right, upon request, to obtain from the issuer of the securities specified information about itself. *Id.* § 230.144A(d)(4)(i).

193. Rule 144A Adopting Release, *supra* note 192, at 80,648 (recognizing exceptions for some specific legitimate U.S. selling activities); see also Silverman & Braverman, *supra* note 55, at 181 (emphasizing same exceptions as in Rule 144A Adopting Release).

194. Reg. S, *supra* note 1, § 230.903.

authorizes less restricted offerings than had previously been allowed without registration, notably relaxing prior practice in the offshore offering domain.¹⁹⁵ Transactions in the Rule 903 safe harbor are divided up into three categories, each imposing different standards depending upon the type of security, the extent of U.S. market interest in that security, and the nature of the issuer.¹⁹⁶ These distinguishing criteria reflect the degree of information available to U.S. investors regarding particular securities and their corresponding potential for flowback into the United States.¹⁹⁷ In order to ensure that the securities "come to rest" abroad, the issuer-distributor safe harbor imposes certain procedural safeguards¹⁹⁸ that vary depending upon the perceived risk of flowback into the United States.¹⁹⁹ The procedural safeguards increase in number and stringency from Category 1 securities²⁰⁰ to Category 3 securities.²⁰¹

1. Category 1: offerings of foreign issuers, overseas directed offerings, and foreign government offerings

The Category 1 safe harbor applies to transactions of foreign issuers with no SUSMI,²⁰² securities offered and sold in ODOs,²⁰³ transactions involving securities backed by the full faith and credit of a foreign government,²⁰⁴ and securities offered and sold pursuant to employee benefit plans of the issuer or its affiliates.²⁰⁵ This category

195. Trachtman, *supra* note 2, at 297 (recognizing significant liberalization in area of offshore offerings).

196. Adopting Release, *supra* note 1, at 80,671. The nature of the issuer refers to its nationality and reporting status. *Id.*; see also Bradley, *supra* note 31, at 186 (describing issuer safe harbor as distinguishing among three categories of offers and sales).

197. Adopting Release, *supra* note 1, at 80,671; see also Wolff, *supra* note 2, at 135 (quoting basis for categorization of securities stated in Reg. S).

198. Adopting Release, *supra* note 1, at 80,671. These procedural safeguards are, in essence, additional restrictions called offering restrictions and transactional restrictions. *Id.*; cf. Wolff, *supra* note 2, at 136 (acknowledging that phrases used in SEC releases are not used in Reg. S itself).

199. Adopting Release, *supra* note 1, at 80,671; see also Bradley, *supra* note 31, at 186 (confirming that safeguards differ by category); Trachtman, *supra* note 2, at 276 (recounting imposition of safeguards dependent upon perceived risk of flowback).

200. Reg. S, *supra* note 1, § 230.903(c)(1).

201. Reg. S, *supra* note 1, § 230.903(c)(3); see also Wolff, *supra* note 2, at 135 (discerning requirements as increasing by number and stringency).

202. Reg. S, *supra* note 1, § 230.903(c)(1)(i)(A)-(D); see *id.* § 230.902(n) (providing official definition of SUSMI); see also *supra* notes 139-49 and accompanying text (examining SUSMI in greater detail).

203. Reg. S, *supra* note 1, § 230.903(c)(1)(ii); see *id.* § 230.902(j) (defining ODO); see also *supra* notes 150-57 and accompanying text (assessing ODO requirement).

204. Reg. S, *supra* note 1, § 230.903(c)(1)(iii); see *id.* § 230.902(e) (defining foreign government as "government of any foreign country or of any political subdivision of a foreign country").

205. Reg. S, *supra* note 1, § 230.903(c)(1)(iv)(A)-(D).

is the least restrictive because qualifying transactions pose the least risk to investors in terms of flowback and availability of information.²⁰⁶ Consequently, Category 1 permits offerings without registration based solely on the two general conditions enumerated in the General Statement: an offshore transaction and no directed selling efforts.²⁰⁷ The SEC points out, however, that, notwithstanding the fact that Category 1 securities comply with the general conditions, trading a substantial amount of the securities soon after their offshore offering may evidence a "plan or scheme to evade" the registration requirements.²⁰⁸ Such trading may indicate that the newly issued securities were offered offshore only to avoid U.S. registration and with the intent of immediately entering the U.S. market.²⁰⁹ While the definition of SUSMI differs for debt and equity,²¹⁰ Category 1 securities either have no SUSMI or are ODOs that are directed to citizens or residents of a single national market.²¹¹

2. *Category 2: reporting issuers' securities and debt, preferred, and asset-backed securities of non-reporting foreign issuers*

Category 2 of the issuer-distributor safe harbor encompasses securities of U.S. and foreign issuers filing periodic reports (reporting issuers)²¹² under the 1934 Act,²¹³ foreign reporting issuers with SUSMI, and non-reporting foreign issuers issuing debt securities.²¹⁴ Non-reporting foreign issuers offering non-participating preferred stock²¹⁵ and asset-backed securities²¹⁶ are also included in this

206. Wolff, *supra* note 2, at 135 (observing that Category 1 was designed to include securities posing fewest risks). See generally Adopting Release, *supra* note 1, at 80,672 (discussing flowback concerns with respect to Category 1 securities).

207. Reg. S, *supra* note 1, § 230.903(c)(1); see also Adopting Release, *supra* note 1, at 80,672 (permitting Category 1 unregistered offerings merely upon compliance with general conditions).

208. Adopting Release, *supra* note 1, at 80,673 n.85 (citing Preliminary Note 2).

209. See Release 4708, *supra* note 54, ¶ 1362 (stating that active U.S. trading of securities subject to offshore offering during or soon after offshore distribution may raise question of "whether a portion of the distribution was in fact being made by means of such trading").

210. See Reg. S, *supra* note 1, § 230.902(n) (differentiating between SUSMI for debt and equity securities); see also *supra* notes 135-49 and accompanying text (probing idea of SUSMI for debt securities and equity securities).

211. Coogan & Kimbrough, *supra* note 24, at 5.

212. See *supra* note 130 (defining reporting issuer under 1934 Act).

213. 15 U.S.C. § 78(a) (1994). The 1934 Act requires issuers to file interim, quarterly, and annual reports. *Id.*; see also Trachtman, *supra* note 2, at 297 (articulating general disclosure requirements of 1934 Act).

214. See Reg. S, *supra* note 1, § 230.903(c)(2) (providing conditions for offer and sale of securities).

215. See Adopting Release, *supra* note 1, at 80,673 (referring to non-participating preferred stock as "outstanding non-convertible capital stock," holders of which have priority in payment of dividends and distribution of assets upon dissolution, but are not entitled to participate in issuer's assets or residual earnings); cf. PESSIN & ROSS, *supra* note 25, at 506 (defining participating preferred shares as those that "offer a bonus dividend if . . . the dividend on

category predicated on the theory that such securities have a largely institutional market, as do debt securities.²¹⁷ The restrictions placed on the second category are fashioned to guard against indirect unregistered public offerings in the United States during the interval that offshore selling efforts are most likely to affect the market.²¹⁸ Debt securities are included in this category not only because of the institutional nature of the debt market,²¹⁹ but also because debt securities can be more easily monitored to detect the use of offshore transactions to evade registration requirements for offers and sales in the United States.²²⁰

In addition to the general conditions imposed by Rule 903(a), the issuer-distributor safe harbor,²²¹ securities in Category 2 are subject to two types of restrictions, referred to as "offering restrictions"²²² and transactional restrictions.²²³ The consequences of failing to adhere to one restriction or the other are extremely different.²²⁴ Failure by any party—issuer, distributor, or affiliate—to comply with the offering restrictions prevents every party from relying on the issuer-distributor safe harbor.²²⁵ Conversely, failure by any party to

common shares of the same issuer exceeds a stated dollar amount" in any quarter).

216. See *supra* note 145 (providing definition of asset-backed security).

217. See Adopting Release, *supra* note 1, at 80,675 (using similarity between market for certain equity securities and debt market as reason for grouping in same category).

218. Adopting Release, *supra* note 1, at 80,675; see also Bradley, *supra* note 31, at 187 (restating effort to protect against unregistered offerings in United States during period in which market is likely to be effected).

219. Adopting Release, *supra* note 1, at 80,675; cf. Coogan & Kimbrough, *supra* note 24, at 6 (reaffirming institutional nature of debt securities market).

220. Adopting Release, *supra* note 1, at 80,675. This language is reminiscent of the language of Preliminary Note 2 to Reg. S. See *supra* note 157 (reciting Preliminary Note 2 regarding evasion of registration requirements).

221. Reg. S, *supra* note 1, § 230.903(a).

222. Reg. S, *supra* note 1, § 230.903(c)(2)(ii); see also Adopting Release, *supra* note 1, at 80,679 (stating that "offering restrictions" are procedures that issuers, distributors, affiliates, and agents must adopt with respect to whole offering in order for transaction to comply with Categories 2 and 3 of Rule 903).

223. Reg. S, *supra* note 1, § 230.903(c)(2)(iii), (iv).

224. See Coogan & Kimbrough, *supra* note 24, at 6 (highlighting significant difference between failure to adhere to offering restrictions and failure to adhere to transactional restrictions).

225. See Coogan & Kimbrough, *supra* note 24, at 6 (discussing impact of failure to comply with offering restrictions); see also Adopting Release, *supra* note 1, at 80,679 (recognizing that failure to utilize offering restrictions precludes reliance upon issuer safe harbor for parties). For example, if A, the issuer, does not agree in writing that all transactions during the restricted period will be made in compliance with Reg. S or registration, or if A does not provide adequate disclosure that the securities are not registered in the United States and cannot be sold to U.S. persons, then neither A, nor B—the distributor,—nor C—an affiliate—can rely on Reg. S's safe harbor for protection.

comply with the transactional restrictions affects only that party and its affiliates.²²⁶

The offering restrictions, in effect, guarantee compliance with the transactional restrictions.²²⁷ They require that each distributor agree in writing that all transactions during the specified restricted period²²⁸ be made according to the provisions of Regulation S, pursuant to the registration requirements of the 1933 Act or an exemption therefrom.²²⁹ Furthermore, the offering restriction requires disclosure that the relevant securities are not registered under the 1933 Act and may not be offered or sold in the United States or to U.S. persons (other than distributors) unless registered or exempt from registration.²³⁰ All offering materials used during the restricted period in connection with the offer or sale of these securities²³¹ must include this disclosure.²³²

The Category 2 transactional restrictions require that no sale made in reliance on the Category 2 safe harbor be made to or for the benefit of a U.S. person, other than a distributor,²³³ during a forty-day restricted period.²³⁴ This restriction compels persons relying on the second issuer safe harbor to adopt procedures to ensure that any person to whom they sell securities is a non-U.S. person.²³⁵ Although somewhat difficult to detect, nominal offers and sales to non-U.S. persons in order to evade the restrictions would not be afforded

226. See Coogan & Kimbrough, *supra* note 24, at 6 (realizing result of non-compliance with transactional restrictions). Suppose, unlike the hypothetical described above, see *supra* note 225, that A (issuer) sells Reg. S securities to Z during the restricted period. A knows that Z may be purchasing the securities for the benefit of a U.S. person. In this case, B (distributor) and C (affiliate) can still rely on the issuer safe harbor, but A cannot.

227. See Adopting Release, *supra* note 1, at 80,679 (noting that noncompliance with restrictions precludes availability of issuer safe harbor for all parties); see also Wolff, *supra* note 2, at 136 (calling offering restrictions "prophylactic measures designed to ensure that offering is conducted in accordance with Regulation S").

228. For the applicable restricted periods for different securities, see Reg. S, *supra* note 1, § 230.903(c)(2)(iii), (iv), and § 230.903(c)(3)(ii)(A), (B), (iii)(A), (B), (iv).

229. Reg. S, *supra* note 1, § 230.902(h)(1).

230. Reg. S, *supra* note 1, § 230.902(h)(2).

231. See Reg. S, *supra* note 1, § 230.902(h)(2)(i)-(iii) (requiring notice that securities have not been registered under Act). Specifically, the offering materials requiring disclosure are any prospectus or offering circular and any advertisements. *Id.* Prospectuses and offering circulars require full disclosure in the underwriting section and a summary on the cover page, whereas advertisements only require summary disclosure. *Id.*

232. Reg. S, *supra* note 1, § 230.902(h)(2).

233. Reg. S, *supra* note 1, § 230.903(c)(2)(iii).

234. Reg. S, *supra* note 1; see also *supra* note 102 (furnishing definition of restricted period as provided in Reg. S); *infra* notes 237-41 and accompanying text (addressing details of restricted period).

235. See Adopting Release, *supra* note 1, at 80,676 (requiring Category 2 issuers to ensure that non-distributor buyers are not U.S. persons); see also Bradley, *supra* note 31, at 187 (same).

safe harbor protection.²³⁶ Significantly, Regulation S does not connect the restricted period with the completion of the securities distribution.²³⁷ Hence, distributors may be able to sell securities in the United States and to U.S. persons after the restricted period, even while there remain allotments (of the offshore offering) unsold by any participant in the distribution.²³⁸ According to the SEC, the common belief that Regulation S securities can be resold into the United States without proper registration after the expiration of the applicable restricted period is mistaken.²³⁹

The other Category 2 transactional restriction obligates a distributor who sells securities during the forty-day restricted period to another distributor, dealer, or anyone receiving compensation, to send a notice stating that such purchaser is subject to the same restrictions on offers and sales as is the distributor.²⁴⁰ Because the transaction restrictions only pertain to transactions dependent upon the issuer-distributor safe harbor, retail purchasers may continue to offer and sell securities to U.S. persons even during the restricted period.²⁴¹ These retail purchasers can rely on section 4(1) of the 1933 Act,²⁴² which provides a registration exemption for transactions by anyone not an issuer, underwriter, or dealer.²⁴³

3. *Category 3: non-reporting U.S. issuers and certain equity securities of non-reporting foreign issuers with SUSMI*

The final issuer-distributor safe harbor category²⁴⁴ is a residual one, available to any issuer who does not qualify for the other catego-

236. See Adopting Release, *supra* note 1, at 80,676 (affording no safe harbor protection to those offering and selling nominally to evade registration).

237. See Silverman & Braverman, *supra* note 55, at 182 (ceasing prior practice of linking restricted period with completion of distribution).

238. Silverman & Braverman, *supra* note 55, at 182.

239. See *Roberts Predicts the SEC Will Revisit Regulation S*, SEC TODAY, Oct. 18, 1994, at 1 [hereinafter *SEC Will Revisit*] (confirming that some issuers mistakenly believe that Reg. S securities can be resold into United States without registration after holding period expires).

240. Reg. S, *supra* note 1, § 230.903(c)(2)(iv); see, e.g., Bradley, *supra* note 31, at 187 (repeating transaction restrictions notice provision); Coogan & Kimbrough, *supra* note 24, at 6 (reiterating added requirement that each distributor selling securities to dealer send confirmation); Silverman & Braverman, *supra* note 55, at 182 (expounding notice requirement applicable to Category 2 securities); Wolff, *supra* note 2, at 136 (confirming transactional restriction of providing notice). Securities professionals (who are not distributors) receiving such a notice are not required to deliver notices. Adopting Release, *supra* note 1, at 80,676.

241. See Coogan & Kimbrough, *supra* note 24, at 6 (deducing that retail purchasers can transact securities during restricted period because transaction restrictions only apply to sales in accordance with issuer-distributor safe harbor).

242. 15 U.S.C. § 77d(1) (1994).

243. See Coogan & Kimbrough, *supra* note 24, at 6 (discussing retailer's reliance on § 4(1) exemption to sell during restricted period).

244. See Reg. S, *supra* note 1, § 230.903(c)(3) (describing safe harbor category).

ries.²⁴⁵ Technically, Category 3 applies to any issuer's securities. The Category essentially codifies a practice originated under Release 4708,²⁴⁶ assigning the most rigorous restrictive procedures to Category 3's constituent issuers. Regulation S does not drastically improve these procedures,²⁴⁷ which are intended to prevent unregistered U.S. distribution where there is a significant likelihood of flowback into the United States and little information is available regarding the issuer and the securities.²⁴⁸ Instead, Reg. S is likely to provide a greater comfort level for non-reporting issuers.²⁴⁹ These issuers can now rely on a safe harbor, as opposed to Release 4708's enforcement position and companion no-action letters.²⁵⁰

The two general conditions (offshore transaction and no directed selling efforts)²⁵¹ apply to Category 3, in addition to the same offering restrictions that apply to Category 2 securities.²⁵² Beyond these stipulations, Category 3 offerings are also subject to the most rigid transactional restrictions.²⁵³ These restrictions distinguish between debt and equity securities, acknowledging the institutional nature of debt securities,²⁵⁴ as well as their lesser likelihood of

245. Adopting Release, *supra* note 1, at 80,679 (including in Category 3 all securities not covered by prior two categories).

246. Adopting Release, *supra* note 1, at 80,664 (adopting procedures similar to those developed under Release 4708 and its related no-action letters); *see also* Coogan & Kimbrough, *supra* note 24, at 7 (noting that Reg. S codifies procedures developed under Release 4708).

247. *See* Coogan & Kimbrough, *supra* note 24, at 7 (arguing that procedures are not greatly improved).

248. *See* Adopting Release, *supra* note 1, at 80,679 (discussing reason for residual category's restrictions).

249. Reg. S, *supra* note 1, § 230.903(c)(3). Category 3 non-reporting issuers include issuers of both debt and equity securities who do not report under the 1934 Act. Adopting Release, *supra* note 1, at 80,679. Such issuers may consist of non-reporting private companies and atypical public companies like special purpose vehicles and mutual insurance companies. Silverman & Braverman, *supra* note 55, at 182.

250. Coogan & Kimbrough, *supra* note 24, at 7. Because Reg. S is an official agency rule, it provides greater certainty than a release or a no-action letter, which merely embodies the current enforcement posture of the SEC staff. *Id.*

251. *See supra* notes 176-93 and accompanying text (considering two general conditions applicable to all securities).

252. *See supra* notes 227-32 and accompanying text (reviewing Category 2 offering restrictions).

253. *See* Reg. S, *supra* note 1, § 230.903(c)(3)(ii)-(iv) (listing transactional restrictions); *see also* Wolff, *supra* note 2, at 138 (emphasizing stringency of Category 3 transactional restrictions); *accord* Bradley, *supra* note 31, at 187 (noting that stringent transactional restrictions apply to deter flowback to U.S. market); Coogan & Kimbrough, *supra* note 24, at 7 (emphasizing that restrictions are stringent due to significant likelihood of flowback to U.S. market).

254. PESSIN & ROSS, *supra* note 25, at 177. A debt security is the general term given to any security that represents money loaned to a borrower that the borrower must pay back to the lender at a future date. *Id.* Commercial paper, notes, bonds, and certificates of deposit are all specific types of debt securities. *Id.* Conversely, an equity security is a certificate that represents a proportional ownership in a corporation. *Id.* at 229. If preference in payment of dividends is shown among owners, the equity security is called "preferred stock"; if there is no preference, it is "common stock." *Id.* at 228.

flowback.²⁵⁵ The restricted period for debt offerings is forty days.²⁵⁶ This forty-day restriction is effected by the requirement that the securities be represented upon issuance by a temporary global security.²⁵⁷ Definitive securities cannot be disbursed until the forty-day restricted period lapses and the beneficial owner²⁵⁸ certifies that he or she is not a U.S. person or is a U.S. person who purchased the securities in an exempt transaction.²⁵⁹

Equity securities face even more stringent transactional restrictions due to the nature of their market and the perceived risk of flowback into the U.S. market.²⁶⁰ Certainly, exempting non-reporting issuers' equity securities from 1933 Act registration is a troubling proposition for the SEC because the prospect of substantial flowback exists where there is insufficient information in the marketplace to ensure investor protection.²⁶¹ Therefore, the restricted period for Category 3 equity securities is one year.²⁶² The conditions further require purchasers²⁶³ to certify that they are neither U.S. persons nor purchasing on behalf of U.S. persons.²⁶⁴ Additionally, purchasers must agree to resell only in accordance with Regulation S provisions, registration, or an exemption therefrom.²⁶⁵ Domestic issuers' shares must contain a legend indicating that the security's transfer is proscribed unless done in accordance with Regulation S.²⁶⁶ Category 3 transactional

255. See Adopting Release, *supra* note 1, at 80,679 (recognizing significant difference between debt and equity securities).

256. Reg. S, *supra* note 1, § 230.903(c)(3)(ii)(A).

257. Reg. S, *supra* note 1, § 230.903(c)(3)(ii)(B).

258. See Reg. S, *supra* note 1, § 230.903(c)(3)(ii)(B) (noting that certification of beneficial ownership is necessary only for persons other than distributors).

259. Wolff, *supra* note 2, at 138. No-action letters under Release 4708 generally followed the same procedures. *Id.* (citing *Proctor & Gamble Co.*, 1985 WL 61525, at *2-3 (S.E.C. Feb. 21, 1985)).

260. See Coogan & Kimbrough, *supra* note 24, at 7 (indicating greater risk of Category 3 equity securities flowback as impetus for increased restrictions); see also *supra* notes 254-55 and accompanying text (acknowledging debt securities' lesser likelihood of flowback).

261. See Gibbons, *supra* note 30, at 374 (acknowledging SEC's concern with idea of flowback where there is insufficient information available to public). The Proposing Release explains the SEC's anxiety. Proposing Release, *supra* note 84, at 89,138. With respect to non-reporting issuers that have a SUSMI, the extent of U.S. market interest alone creates a greater likelihood of flowback. *Id.* at 89,136, 89,139. In the case of non-reporting domestic issuers, securities are more likely to flowback because securities are inclined to trade in the market where the issuer's principal business occurs and where most employees are located. *Id.* Either way, such issuers do not report under the 1934 Act, thereby limiting the amount of information available in the U.S. marketplace. *Id.*

262. Reg. S, *supra* note 1, § 230.903(c)(3)(iii)(A).

263. See Reg. S, *supra* note 1, § 230.903(c)(3)(iii)(B)(1) (excluding distributors from category of purchasers).

264. See Reg. S, *supra* note 1, § 230.903(c)(3)(iii)(B)(1) (noting that purchaser certification is also required for U.S. person who purchased securities in exempt transaction).

265. Reg. S, *supra* note 1, § 230.903(c)(3)(iii)(B)(2).

266. Reg. S, *supra* note 1, § 230.903(c)(3)(iii)(B)(3).

restrictions also require that the issuer decline registration of any securities transfer not done in accordance with the Regulation.²⁶⁷ If, however, foreign law prevents the issuer from refusing to register the transfer or if the securities are in bearer form, other reasonable procedures²⁶⁸ must be implemented.²⁶⁹ Finally, distributors selling any type of Category 3 securities to a dealer, distributor, or person receiving compensation before the restricted period expires must forward a notice stating that the purchaser is subject to the same restrictions on offers and sales as the distributor.²⁷⁰

E. Rule 904 Resale Safe Harbor

Rule 904 exempts some secondary market trading from the section 5 registration requirements.²⁷¹ This safe harbor applies to resales outside the United States by unaffiliated investors or, more basically, to offers and sales to *anyone other than* issuers, distributors, or affiliates and agents.²⁷² Rule 904 is accessible for the resale of any securities offshore, irrespective of whether or not the securities were acquired pursuant to Regulation S.²⁷³ In no way does Rule 904 provide any protection for investors engaging in short sales (because short sales are not resales outside the United States).²⁷⁴

1. Safe harbor for non-securities professionals and officers and directors

Non-securities professionals are persons other than dealers and persons receiving compensation for sales.²⁷⁵ Such persons may immediately avail themselves of this resale safe harbor simply by complying with the general conditions of Rule 904.²⁷⁶ If these

267. Reg. S, *supra* note 1, § 230.903(c)(3)(iii)(B)(4). The issuer is required to refuse either by contract or by an article, bylaw, or charter provision. *Id.*

268. See Reg. S, *supra* note 1, § 230.903(c)(3)(iii)(B)(4) (noting that another reasonable procedure would be to place legends on securities).

269. Reg. S, *supra* note 1, § 230.903(c)(3)(iii)(B)(4).

270. Reg. S, *supra* note 1, § 230.903(c)(3)(iv).

271. See Gibbons, *supra* note 30, at 376 (stating that certain secondary market trading in unregistered securities is exempt).

272. Reg. S, *supra* note 1, § 230.904; see also Wolff, *supra* note 2, at 139 (reiterating who may invoke Reg. S resale safe harbor provision).

273. See Adopting Release, *supra* note 1, at 80,681 (discussing availability of resale safe harbor); see also *supra* notes 176-93 and accompanying text (describing mechanics of safe harbor).

274. See Reg. S, *supra* note 1, § 230.904 (applying only to resales outside United States); see also *infra* notes 306-23 (describing process of "short sale" as one where investor sells security without prior ownership, gambling on ability to purchase security at decreased price before giving to broker).

275. See Adopting Release, *supra* note 1, at 80,680 (applying resale safe harbor to persons other than dealers, those receiving compensation, and affiliated officers and directors).

276. See Reg. S, *supra* note 1, § 230.904(a)-(b) (requiring transactions to be offshore and prohibiting directed selling efforts of securities in United States). Suppose that investor A wants

conditions are satisfied, the resale is considered to be outside the United States and, therefore, is exempt from the registration requirements.²⁷⁷ Affiliated officers and directors of the issuer or distributor are also entitled to rely on the resale safe harbor, as long as they are affiliates exclusively because of their position,²⁷⁸ and not because the affiliated person holds more than ten percent of the company's outstanding stock.²⁷⁹ In conjunction with the two general conditions, there is a requirement that no special selling compensation,²⁸⁰ other than the ordinary broker's commission, be paid in connection with the offer or sale.²⁸¹

2. *Safe harbor for dealers*

Resales by dealers²⁸² prior to the end of the restricted period are subject to two additional conditions.²⁸³ First, neither the dealer nor any agent may knowingly offer or sell to a U.S. person during the restricted period.²⁸⁴ Second, if the seller knows the purchaser is a dealer, the seller must send a confirmation disclosing that the securities may be sold during the restricted period only in accordance with Regulation S, pursuant to registration, or pursuant to another exemption.²⁸⁵

to resell securities to B that investor A originally bought from Z two weeks earlier. A can resell to B in reliance on Rule 904 as long as A is not a dealer and as long as the transaction occurs outside the United States (as set forth in the general requirements of Rule 903). If, however, the transaction is not deemed to occur outside the United States, then Rule 904 does not provide any resale safe harbor protection for A.

277. See Reg. S, *supra* note 1, § 230.904(a)-(b) (delineating additional requirement prohibiting direct sales of securities in United States).

278. See Reg. S, *supra* note 1, § 230.904(c)(2) (noting unavailability of safe harbor when fees other than customary broker's commission exist).

279. PESSIN & ROSS, *supra* note 25, at 13. An affiliated person, also known as a "control person," is one who can influence a corporation's management decisions. *Id.* Such persons can be directors, elected officers, immediate family members, or even holders of 10% or more of the corporation's outstanding stock. *Id.*

280. Reg. S, *supra* note 1, § 230.904(c)(2). Compensation for purposes of the resale provision includes any selling concession, fee, or other remuneration. *Id.*

281. Reg. S, *supra* note 1, § 230.904(c)(2).

282. Securities Act of 1933, 15 U.S.C. § 77(b)(12) (1994). A Dealer is defined in § 2(12) of the 1933 Act as "any person who engages either for all or part of his time, directly or indirectly, as agent broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person." *Id.*

283. Reg. S, *supra* note 1, § 230.904(c)(1)(i)-(ii).

284. Reg. S, *supra* note 1, § 230.904(c)(1)(i).

285. Reg. S, *supra* note 1, § 230.904(c)(1)(ii).

III. SHORT SALES AND OTHER RECENT ALLEGATIONS

The SEC expressed its usual hesitation regarding the limitation of regulatory jurisdiction in Reg. S's Preliminary Note 2. The Commission stated:

In view of the objective of these rules and the policies underlying the Act, Regulation S is not available with respect to any transaction or series of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act. In such cases, registration under the Act is required.²⁸⁶

One commentator noted that, at the inception of Reg. S, many people thought "that this type of provision . . . would not be used much and [was] necessary [only] to prevent abuse."²⁸⁷ Almost five years later, however, the presumption that this preliminary note was almost irrelevant is increasingly inaccurate.

Since 1991, large and small companies alike have been exploiting Regulation S²⁸⁸ to perform what at least one journalist has classified as "a host of shady transactions."²⁸⁹ Small companies in particular (the unintended beneficiaries of Reg. S),²⁹⁰ are trying to capitalize on the rules in various ways.²⁹¹ Both issuers and investors are taking restricted securities that cannot be sold publicly in the United States²⁹² and engaging in offshore transactions solely to "wash"²⁹³

286. Reg. S, *supra* note 1, at Preliminary Note 2; see *supra* note 157 (repeating Preliminary Note 2).

287. Trachtman, *supra* note 2, at 296 (asserting that SEC would protest that Reg. S provision would not be used often and practitioners might respond that such broad regulatory safety valve would pose unacceptable risks).

288. See SEC v. Westdon Holding & Inv., Inc., No. 91-7531, 1991 WL 288312, at *1 (S.D.N.Y. Nov. 14, 1991) (filing civil injunctive action against defendants for violating § 5 of 1933 Act in connection with purchase of Reg. S securities and subsequent illegal distribution of unregistered shares in United States).

289. See Cohen, *supra* note 4, at C1 (emphasizing SEC officials' belief that companies and buyers are using Reg. S to evade registration requirements, resulting in host of shady transactions).

290. Cf. Cohen, *supra* note 4, at C1 (crediting author of Reg. S as saying that regulation's intent was to ease burden on large, financially sound companies wanting to reach foreign markets).

291. See *infra* notes 292-323 and accompanying text (describing practices of "washing off" restrictions and short-selling).

292. Cohen, *supra* note 4, at C1. Companies and investors are washing restrictions off otherwise restricted securities. *Id.* Restricted securities are securities that are acquired either directly or indirectly from issuers (or affiliates) in transactions not involving any public offerings. Adoption of Rule 144, Exchange Act Release No. 33-5223, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,487, at 81,049 (Jan. 11, 1972) [hereinafter Rule 144]. Such securities cannot be sold publicly in the United States because they are not registered. 15 U.S.C. § 77(e)(c) (1994).

the restrictions off those securities in anticipation of their return to the U.S. market upon expiration of the restricted period.²⁹⁴ The intent of Reg. S, however, was for shares to be held overseas as long-term investments,²⁹⁵ not to be immediately brought back into the United States. Moreover, as evidenced by Preliminary Note 2, the SEC never intended Regulation S to act as a mechanism for "washing off" restrictions.²⁹⁶

What Regulation S did intend was to allow and encourage domestic issuers to compete in global markets.²⁹⁷ To facilitate this goal, the SEC abandoned its most burdensome yet equally valuable restriction, namely, 1933 Act registration. In order to maintain the integrity and ensure the viability of the U.S. financial markets, however, completely unrestricted transactions are impossible. The transactional and offering restrictions²⁹⁸ imposed on Reg. S offers and sales are necessary to safeguard against exploitation of the U.S. capital markets, or persons investing in them, in much the same way that registration would. By purposely "washing off" these restrictions abroad, issuers and purchasers put the U.S. market and its investors at risk.²⁹⁹

293. See Problematic Practices, *supra* note 43, at 35,664 (noting "washing off" resale restrictions like Rule 144 restricted securities' required holding period).

294. See Cohen, *supra* note 4, at C1 (noting SEC Commissioner Richard Roberts' suspicion that some Reg. S offerings are arranged solely to "wash" restrictions off shares before bringing them back into United States); see also *Report on Reg. S*, *supra* note 42, at 636 (noting same concern in letter from Rep. Markey); *SEC Staff*, *supra* note 41, at 696 (same). See generally Problematic Practices, *supra* note 43, at 35,664 (describing various practices whereby market participants conduct placements offshore temporarily to evade U.S. registration while leaving or returning substantial portion of economic risk to U.S. market).

295. See Cohen, *supra* note 4, at C1 (recognizing that intent of Reg. S was for shares to be held long-term by European investors); see also *SEC's Walter*, *supra* note 41, at 366 (quoting Elisse Walter, Deputy Director of SEC's Division of Corporate Finance, stating that basic proposition underlying Reg. S is to govern distributions of securities abroad).

296. See *supra* notes 157, 286 and accompanying text (disallowing plans or schemes to evade registration requirements even when Reg. S's rules are technically met).

297. See generally Adopting Release, *supra* note 1, at 80,665 (adopting territorial approach to § 5 registration provision and recognizing globalization of securities markets); Problematic Practices, *supra* note 43, at 35,665 (affirming Reg. S's intent to provide U.S. issuers with effective alternative for raising capital); Cohen, *supra* note 4, at C1 (reporting intent of SEC to encourage issuers to issue securities overseas); Wolff, *supra* note 2, at 101 (calling regulation on territorial basis "prerequisite to the development of an effective global system of international securities regulation").

298. See *supra* notes 222-70 and accompanying text (interpreting transactional and offering restrictions).

299. See Adopting Release, *supra* note 1, at 80,675 (noting need for restrictions in order to protect U.S. investments). Increasing the potential of the securities flowback into the United States at a time when little information regarding such securities or their issuers is available poses a substantial risk to investors in the U.S. market who may buy the securities without any prior knowledge of the securities' stability. In addition, sales of such "washed off" securities may create artificial prices and eventually affect investor confidence. On the other hand, the original purpose of Reg. S was to provide U.S. issuers with increased access to global markets by exempting these issuers from the burden of registration. Fleming, *supra* note 32, at 13. By imposing additional restrictions on Reg. S offerings which were actually intended to eliminate

"Washing off" restrictions through Reg. S offerings has become both an important financing technique for infant companies³⁰⁰ and a means of raising money quickly for those that are loss-ridden.³⁰¹ Issuers can perform a Reg. S offering quickly³⁰² and discreetly because there are no U.S. registration requirements. Consequently, issuers can save up to half of what a regular public offering would cost.³⁰³ Because of the combination of the forty-day restricted period and the lack of registration requirements, the Reg. S paper can be offered at a substantial discount³⁰⁴ from the issuer's current stock price in the U.S. markets.³⁰⁵

The availability of discounted Regulation S shares has prompted investors to engage in "short sales."³⁰⁶ Technically, a short sale is "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."³⁰⁷ Such sales are generated because the seller anticipates a decline in a security's price³⁰⁸ and seeks to profit from the decline.³⁰⁹ The general procedure for effecting a short sale is relatively simple. First, a customer gives a broker an order to sell stock short, which is executed and recorded as any other sale would be.³¹⁰ The short-seller must deliver the stock sold to the purchaser within the period specified by the SEC rules, but because the short-seller has no such shares, he or she must find them

restrictions, the SEC may be abrogating its own objectives.

300. See Problematic Practices, *supra* note 43, at 35,665 (calling Reg. S "an important financing tool" for small business issuers); see also Fleming, *supra* note 32, at 13 (touting Reg. S as significant method of financing for many young companies).

301. See Cohen, *supra* note 4, at C1 (recognizing that Reg. S transactions are attractive to many companies needing to raise cash quickly).

302. See Fleming, *supra* note 32, at 13 (stating that Reg. S issues offer quick project financing).

303. Fleming, *supra* note 32, at 13.

304. Fleming, *supra* note 32, at 13. Discounts are often equal to anywhere between 10 and 40% off the issuers' current stock price in U.S. markets. *Id.*; see also Cohen, *supra* note 4, at C1 (describing discount to offshore buyers as 20 to 30% below U.S. market prices).

305. See Cohen, *supra* note 4, at C1 (providing examples of companies benefitting from Reg. S via below-market sale prices).

306. See *Report on Reg. S*, *supra* note 42, at 636 (describing rule as creating incentives for foreign speculators to engage in short sales and thereby drive down share prices); see also PESSIN & ROSS, *supra* note 25, at 646 (defining short sale); Cohen, *supra* note 4, at C1 (relating basic procedure for completing short sale); *infra* notes 307-23 and accompanying text (describing process of short-selling).

307. LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 650 (2d ed. 1988) (citing Rule 3b-3).

308. PESSIN & ROSS, *supra* note 25, at 646.

309. PESSIN & ROSS, *supra* note 25, at 646.

310. 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3198, 3198-99 (3d ed. 1991). The purchaser does not know whether the purchaser is buying from an owner of stock or a short-seller. *Id.* at 3199.

elsewhere.³¹¹ Usually, the broker will borrow the stock from another broker on the short-seller's behalf.³¹² Concurrently, the seller's broker must deposit the market value of the borrowed stock with the lending broker.³¹³ The seller's broker will then deliver the borrowed stocks to the person who purchased them from the short-seller.³¹⁴ When the short-seller eventually covers,³¹⁵ the seller's broker purchases the stock in the market (hopefully after the price has declined) and returns it to the lending broker in exchange for the deposit.³¹⁶ At this point the transaction is complete.³¹⁷ Selling short in anticipation of a price decline, therefore, will enable the speculator to "cover," or make delivery of a stock, by buying it at the lesser price.³¹⁸ If the decline occurs, the short-seller realizes a profit equal to the difference between the original sales price and the lower purchasing price (also called the covering price), minus transaction costs.³¹⁹

When a short sale is accomplished involving a security that is publicly traded in the United States and also sold abroad pursuant to Reg. S, the seller has no need to anticipate a decline in the price of the security.³²⁰ Because the security was sold at a discount outside the United States,³²¹ there is usually a built-in price differential in the short-seller's favor, compared with the price of the same security registered and sold within the U.S. market.³²² The short-seller,

311. 7 LOSS & SELIGMAN, *supra* note 310, at 3199.

312. 7 LOSS & SELIGMAN, *supra* note 310, at 3199.

313. 7 LOSS & SELIGMAN, *supra* note 310, at 3199. The deposit varies with fluctuations in the security's market price. If the price increases, so must the deposit. Conversely, if the price declines, the borrowing broker may request a refund of the difference. Nevertheless, the lender is entitled to have a deposit equal to the stock's market value at all times. *Id.*

314. 7 LOSS & SELIGMAN, *supra* note 310, at 3199.

315. PESSIN & ROSS, *supra* note 25, at 155. "Cover" is the verb that designates a closing transaction on a short-sale contract. *Id.* Covering is the functional equivalent of making delivery of a stock to a lender. 7 LOSS & SELIGMAN, *supra* note 310, at 3198.

316. 7 LOSS & SELIGMAN, *supra* note 310, at 3199.

317. 7 LOSS & SELIGMAN, *supra* note 310, at 3199.

318. 7 LOSS & SELIGMAN, *supra* note 310, at 3198; see also LOSS, *supra* note 307, at 645 (describing mechanics of modern short sale according to 1934 report of Senate investigation of STOCK EXCHANGE PRACTICES, REPORT OF COMM. ON BANKING & CURRENCY, S. REP. NO. 1455, 73d Cong., 2d Sess. 50-51 (1934)). The lesser price results from the decline in price that formed the basis for the short sale. 7 LOSS & SELIGMAN, *supra* note 310, at 3198.

319. See 7 LOSS & SELIGMAN, *supra* note 310, at 3198 (explaining procedure for realizing profit); see also LOSS, *supra* note 307, at 645 (citations omitted) (illustrating same procedure).

320. 7 LOSS & SELIGMAN, *supra* note 310, at 3198. The decline is guaranteed by the discounted Reg. S security. *Id.*

321. Cohen, *supra* note 4, at C1. The Reg. S shares can be sold at a discount because the issuer does not need to spend the time or money registering them, thus allowing the sales to be completed faster. *Id.*

322. See generally Cohen, *supra* note 4 (discussing unintended loophole in Reg. S fostered by commonly discounted Reg. S stock).

therefore, is virtually guaranteed a profit, consisting of the difference between the sale price (the price of the U.S. security) and the covering price (the price of the same security sold overseas pursuant to Reg. S).³²³ The result is a completely riskless transaction.

Although it is unclear whether short sales and other abuses of Regulation S are commonplace, the frequency of such practices appears to be increasing.³²⁴ Not surprisingly, Congress has expressed concern about the impact that Regulation S may have on U.S. markets due to the "incentives the rule . . . creates for foreign speculators to drive down share prices . . . in order to allow delivery of the borrowed shares with cheaper Regulation S securities."³²⁵ In fact, as recently as April 1994, Representative Edward Markey (D.

323. See 7 LOSS & SELIGMAN, *supra* note 310, at 3198 (proffering that short-sellers seek profit and describing way in which profit accrues); see also *supra* note 319 and accompanying text (communicating procedures for realizing profit).

324. See Problematic Practices, *supra* note 43, at 35,664 (noting SEC's awareness of several instances where securities purchasers engage in investment strategies that "transfer benefits and burdens of ownership back to U.S. market during restricted period"); Cohen, *supra* note 4, at C1 (acknowledging increase in frequency of short sales). The SEC's lack of clarity regarding how to best address Reg. S abuses is evident from the relatively small number of enforcement actions it has brought since 1990. Currently, only three enforcement actions have been brought based on abuses of Reg. S. *E.g.*, United States v. Sung & Feher, Securities Act Litigation Release No. 14500, 1995 U.S. Dist. LEXIS 1233 (M.D. Fla. May 15, 1995); SEC v. Westdon Holding & Inv., Inc.; No. CIV. A. 91-7531, 1991 WL 288312 (S.D.N.Y. Nov. 7, 1991); and SEC v. Softpoint, Inc., Securities Act Litigation Release No. 14480, 1995 U.S. Dist. LEXIS 1032 (S.D.N.Y. Apr. 27, 1995). In *Sung & Feher*, one of the SEC's first criminal prosecutions, the SEC alleged that certain directors and officers of Member Services Corp. caused the company to issue over 1.4 million unregistered shares to Canadian brokerage accounts controlled by the directors, supposedly in reliance on Reg. S. *Sung & Feher*, 1995 U.S. Dist. LEXIS 1233, at *2. After some price manipulation, the defendants then allegedly sold the unregistered shares into the U.S. market for \$5.5 million. This matter is still under SEC investigation. *Id.* at *3.

The SEC also charged Softpoint, Inc. and two of its directors with issuing unregistered common shares of its stock to foreign distributors, controlled by Softpoint's president, in exchange for marketing rights, in purported reliance on Regulation S. *Softpoint*, 1995 U.S. Dist. LEXIS 1032, at *1-*2. Allegedly, the Softpoint directors subsequently directed the sale of the unregistered shares back into the United States, with most of the proceeds going to the company and the remainder going to the directors who arranged the sales. *Id.* at *3.

In *Westdon*, the SEC brought a civil injunctive action in U.S. District Court in New York seeking a temporary restraining order, asset freeze, preliminary and permanent injunctions, disgorgement of illegally obtained profits, and civil penalties for violating the 1933 Act § 5 registration provisions and the 1934 Act § 13(d) beneficial ownership reporting provisions. *Westdon*, 1991 WL 288312, at *1. Among others things, the suit alleged violations of the federal securities laws in connection with the purchase and distribution of securities to unsuspecting U.S. purchasers without registration or an exemption therefrom. *Id.* The sales made to the defendants were made in purported reliance on Reg. S. *Id.* Less than seven days after the SEC brought its suit, the U.S. District Court issued a preliminary injunction and asset freeze. See SEC v. Westdon Holding & Inv., Inc., No. CIV. A. 91-7531, 1991 WL 288360, at *1 (S.D.N.Y. Nov. 14, 1991). In June 1992, the court entered a Final Judgment of Permanent Injunction against one of the defendants. SEC v. Westdon Holding & Inv., Inc., No. CIV. A. 91-7531, 1992 WL 136673, at *1 (S.D.N.Y. June 5, 1992). The defendant consented to the injunction without admitting or denying the SEC's allegations. *Id.* at *1. The defendant also agreed to return the shares of stock that were in his possession. *Id.* at *1-*2.

325. Markey Letter, *supra* note 42.

Mass.), the then-chairman of the House Subcommittee on Energy and Commerce, Telecommunications and Finance, wrote to the SEC requesting a report on Regulation S and questioning whether the Regulation should be substantially modified or even repealed.³²⁶ Because of several press reports alleging widespread abuses of Reg. S,³²⁷ the SEC stated that it is monitoring the situation carefully.³²⁸ Despite such oversight, however, to date the SEC has brought few enforcement proceedings for abuse of Regulation S.³²⁹

IV. RECOMMENDATIONS

Both issuers and investors are manipulating the registration exemption that Regulation S provides.³³⁰ It is not certain at this time, however, that the potential harm caused by the unintended uses rises to a level that requires procrustean SEC action. Activities such as short-selling with Reg. S stocks, or engaging in Reg. S transactions in order to "wash" restrictions off securities are *presumed* to be detrimental to both the U.S. markets and those investing in them. Because the primary responsibility of the SEC and U.S. securities laws is to safeguard the proper functioning of the U.S. market and to protect its investors from unsuspected risks,³³¹ it seems logical that the harmful activities mentioned above must be curtailed. In addition to their inherent disregard for SEC intentions, activities like short-selling and "washing off" restrictions are blatantly contradictory to the 1933 Act's registration and public disclosure requirements. Until recently, the SEC has taken few affirmative steps to address the problems that Reg. S has generated. Before any action to modify

326. Markey Letter, *supra* note 42; see also SEC Staff, *supra* note 41, at 696 (seeking determination of most effective method to address abuses).

327. See generally Cohen, *supra* note 4, at C1 (pointing out loophole in Reg. S that SEC never intended); Fleming, *supra* note 32, at 13 (reporting Europeans being offered "back door" U.S. capital increases called Reg. S issues); *Pushing Envelope*, *supra* note 41, at 355 (quoting Linda Quinn, Director of SEC's Corporation Finance Division, as stating that problem exists if rule used only to wait out 40-day restricted period and then get securities back into United States).

328. See generally *Pushing Envelope*, *supra* note 41, at 355 (proclaiming that SEC staff will be "out and about" watching what is occurring with Reg. S (quoting Linda Quinn, Director, SEC, Corporate Finance Division)); *Roberts Urges MJDS Approach Over Global Disclosure Standards*, 26 Sec. Reg. & L. Rep. (BNA) No. 11, at 407 (Mar. 18, 1994) (expressing necessity for staff to study actual use and effects of Reg. S).

329. See *supra* note 324 (summarizing only enforcement action brought by SEC to date).

330. Problematic Practices, *supra* note 43, at 35,663 (recognizing many problematic practices that have developed since Reg. S was adopted); see, e.g., Cohen, *supra* note 4, at C1 (alleging that Reg. S issuers and buyers are engaging in questionable transactions to evade registration requirements); Fleming, *supra* note 32, at 13 (quoting SEC officials citing instances of "bogus Reg. S issues"); *Pushing Envelope*, *supra* note 41, at 355 (reporting that people are "pushing the envelope" of Reg. S safe harbor).

331. Proposing Release, *supra* note 84, at 89,136, 89,139.

Regulation S is undertaken prematurely, however, the SEC must first study the Regulation's actual impact on the market and on U.S. investors.³³² Only after a thorough study of Regulation S's practical ramifications can the SEC coherently articulate exactly what significant damage, if any, has emerged, and how the SEC can remedy it.

If the SEC determines Regulation S to be significantly defective, a few options exist for coping with its shortcomings. The breadth of Reg. S's negative impact on U.S. markets will dictate the extent of the remedial action that must be undertaken. Unfortunately, virtually any modification of the Regulation that the SEC might attempt could conceivably stifle Regulation S's objectives. One option for the SEC is to lengthen the restricted period of Category 2 securities³³³ with the hope of discouraging short-selling. Ideally, lengthening the restricted period would discourage short-selling because it would extend the period that the short-seller must wait before replacing the borrowed security. This would make the transaction riskier, because the longer the short-seller must hold the Reg. S security, the greater the chance that the U.S. market price will decline. Yet, extending the restricted period might actually be useless. No matter how long the restricted period is, if the short-seller buys the security near the end of that period, he or she still need only wait a short length of time before covering the sale with the Reg. S security. At that point, the market will look much the same as it will after the restricted period expires.

A second possibility for the SEC to explore is an amendment to Regulation S that would state, in essence: "This Regulation does not exempt from the definition of distributor³³⁴ persons who engage in short sales of a security or its economic equivalent (meaning an equivalent class of shares)." Primarily, such a provision would allow

332. In an effort to address problematic practices that have arisen with respect to Regulation S and to solicit comment regarding the need to limit such abuses, the SEC issued an interpretive release in July 1995. *Problematic Practices*, *supra* note 43, at 35,663. While the release does not conclusively change the Regulation in any way, it will generate comments with which the SEC will determine whether or not any remedial action is necessary. *Id.*

333. *SEC Will Revisit*, *supra* note 239, at 1 (viewing increasing Category 2 securities' holding period as way to eliminate abuses). Category 1 securities do not pose significant risk if they flowback into the United States because the issuers are reporting issuers and, therefore, information regarding them is already available to U.S. investors. Reg. S, *supra* note 1, § 903(c)(1). Additionally, Category 3 securities are already subject to additional transactional restrictions that make it more difficult for investors to bring them back into the United States. *Id.* § 903(c)(3).

334. See PESSIN & ROSS, *supra* note 25, at 196 (equating distributor with underwriter of mutual fund shares); see also *infra* note 335 (providing statutory definition of underwriter).

the SEC to treat short-sellers as statutory underwriters,³³⁵ who buy securities with a "view to distribute," and bring enforcement actions against them for violating section 5.³³⁶ There would be no "good faith" defense available to such individuals, as there may be if such persons were not treated as distributors.³³⁷

This amendment, however, may also be impractical. It would cast a dangerously wide net over anyone who qualifies as a distributor for the purposes of Regulation S. Because it is difficult to ascertain the purchaser's mental state at the time of acquiring the securities,³³⁸ purchasers who bought the securities without the intent to distribute, and subsequently sold short for some reason, might be unreasonably subjected to enforcement proceedings.

The most sensible approach for the Commission to pursue, in the event that Regulation S requires modification, would be to amend the Regulation to include a provision limiting resales in the United States.³³⁹ This provision would have the effect of eliminating any safe harbor protection for resales of Reg. S securities into the United States. It would effectively extend the restricted period preceding resale indefinitely. While resales outside the United States would continue to be permitted at any time, Reg. S securities would be treated as "restricted securities" under Rule 144³⁴⁰ and resales into the United States would require compliance with section 5 of the 1933 Act or an exemption therefrom. This proposal would quell what SEC Commissioner Richard Y. Roberts calls "some issuers' mistaken[] belie[f] that once the forty-day restricted period of the safe harbors has been satisfied, the securities can be resold into the United States

335. See Securities Act of 1933, 15 U.S.C. § 77(b)(11) (1994) (specifying role of underwriter). The statute states that an underwriter is:

any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.

Id.

336. *Id.* § 5.

337. *Id.*

338. Rule 144, *supra* note 292, ¶ 81,053 (admitting difficulty in verifying purchaser's mental state at time of securities purchase).

339. See Regulation D—Revision of Certain Exemptions from Registration under the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106, at 84,907 (Mar. 8, 1982) [hereinafter Regulation D Revision]; Regulation D—Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.501 to .508, § 230.502(d) (1993) [hereinafter Reg. D] (providing limitation on resales of certain securities).

340. Rule 144, *supra* note 292, ¶ 81,049 (defining restricted securities as those "acquired directly or indirectly from issuers or from affiliates of such issuers in transactions not involving any public offerings").

without registration or exemption.”³⁴¹ Although such a proposal may appear to be a rather “draconian alternative,”³⁴² its effect would be to discourage non-U.S. investors from investing for the sole purpose of making a quick profit. Those non-U.S. investors who are currently investing for the long-term would not be significantly affected.

In order to affect this proposed amendment, issuers would need to offer for their offshore Regulation S offerings, a class of shares distinct from those classes currently offered in the United States. Establishing a separate class of shares is relatively simple³⁴³ and is not costly. The security’s transfer agent³⁴⁴ would be required to maintain separate records for the different share classes and would be alerted to the difference between the shares by their respective Committee on Uniform Securities Identification Procedures (CUSIP) numbers.³⁴⁵ Moreover, the issuer would be required to exercise reasonable care to assure that the purchasers of the Reg. S securities are not underwriters within the meaning of section 2(11) of the 1933 Act.³⁴⁶ To demonstrate reasonable care, the issuer may: (1) make a reasonable inquiry to determine if purchasers are buying the securities for themselves or for others; (2) supply written disclosure to every purchaser prior to sale that the securities are unregistered, and therefore, cannot be resold unless they are registered or sold pursuant to an exemption; or (3) place a legend on the certificate that states that they have not been registered and enumerates the restrictions on transfer and resale.³⁴⁷

It is important to note that, as with any proposal for substantially revising a regulation, there are potential pitfalls. First, if this resale restriction profoundly impacts the price that an issuer can get for its securities abroad, there may be significant costs attached. When an

341. *SEC Will Revisit*, *supra* note 239, at 1 (quoting SEC Commissioner Roberts).

342. *See SEC Will Revisit*, *supra* note 239, at 2 (characterizing idea of treating Reg. S securities as restricted securities as “draconian”).

343. In order to establish a separate class of shares for Reg. S offerings, the Board of Directors would need to designate a different name for the shares, as well as spell out the different rights and liabilities of the unregistered shares offered for sale outside the United States. This would be done in the securities’ bylaws.

344. PESSIN & ROSS, *supra* note 25, at 743. Pessin and Ross define a transfer agent as an institution responsible for the revocation of certificates that are sold, bequeathed, or gifted and the reissuance of new certificates to the new owner. *Id.* The transfer agent is generally a commercial bank, although it can be the issuer itself. *Id.*

345. PESSIN & ROSS, *supra* note 25, at 169. CUSIP stands for the Committee on Uniform Securities Identification Procedures. A CUSIP identification number is a “nine alphanumeric symbol that is compatible with U.S. broker/dealer operations.” *Id.*

346. 15 U.S.C. § 2(11) (1994).

347. Reg. D, *supra* note 339, § 230.502(d).

issuer offers its shares at a discount pursuant to Regulation S, obviously the issuer does not profit as it would by selling the shares at their U.S. market price. On the other hand, that issuer does not incur as much expense as it would if it had to register under the 1933 Act before commencing sales. This trade-off is still advantageous for many large companies. If, however, the Reg. S shares were prohibited from being readily resold into the United States, the possibility exists that these shares may sell at an even bigger discount abroad as a result of their lack of resale value in the U.S. market. Some issuers may view such a deep discount as a disincentive to performing Reg. S offerings.³⁴⁸ Others, like Primerica, would likely still do Reg. S offerings because they are both "efficient and effective."³⁴⁹

Second, and equally consequential, is the prospect that this proposal would run counter to the trend that has emerged over the last fifteen years of assuring issuers who sell securities in international markets that there will be no liability if they comply with the rules.³⁵⁰ Several significant questions may arise. For example, suppose an issuer sells securities abroad with the "reasonable belief" that such securities will remain abroad. A purchaser, however, proceeds to resell this issuer's securities in the United States. Is the issuer then liable because of its role in this "distribution" of unregistered securities into the United States? What would the issuer need to do in order to prove its "reasonable belief" that its securities would remain abroad? If liability may result for the issuer, then this proposal is contrary to the current trend because the issuer has no means of being certain that it can offer its securities without liability. A provision like that in Regulation D,³⁵¹ which requires the issuer

348. See Cohen, *supra* note 4, at C1 (providing example of Reg. S stock's discount and recounting that Reg. S issuer's U.S. stock price fell sharply day after Reg. S offering).

349. Cohen, *supra* note 4, at C1 (quoting President of New York-based Travelers, Inc., owner of Smith Barney Shearson Inc., United States' second-largest brokerage house).

350. See generally Reg. D, *supra* note 339; Rule 144, *supra* note 292. These SEC regulations seek to "make more certain the conditions under which . . . securities may be [sold] and resold publicly without prior registration under the Securities Act." Rule 144, *supra* note 292, ¶ 81,040.

351. See Reg. D, *supra* note 339, § 230.502(d). The provision limiting resales in Regulation D states:

Except as provided in § 230.504(b)(1), securities acquired in a transaction under Regulation D shall have the status of securities acquired in a transaction under section 4(2) [§ 77(d)(2)] of the Act and cannot be resold without registration under the Act or an exemption therefrom. The issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(11) [§ 77(b)(11)] of the Act, which reasonable care may be demonstrated by the following:

- (1) Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons;
- (2) Written disclosure to each purchaser prior to sale that the securities have not been registered under the Act and, therefore, cannot be resold unless they are

to exercise reasonable care to assure that the purchasers are not underwriters, may be enough to relieve the issuer of liability. Additionally, it would be possible to affirmatively place the burden on purchasers to prove that they are not buying with the intent to resell in the U.S. market. In either instance, the proposal would not be contrary to the trend.

It is prudent that the SEC perform a cost-benefit analysis of the potential additional burdens on or indirect costs to companies associated with any new restrictions imposed in Reg. S offerings³⁵² after determining the extent of Regulation S's harm. If, in practical application, Reg. S is severely damaging U.S. markets and jeopardizing U.S. investor safety more than it is benefiting the large issuers that it was meant to assist, then perhaps the rule should be modified. If, however, large issuers are flourishing as a result of Regulation S, and U.S. markets and U.S. persons investing in them are not seeing excessive declines in share prices due to the artificial supply provided by Reg. S shares, or investor confidence is not being significantly affected, then it would seem that the unintended loophole³⁵³ in Regulation S need not be closed. The SEC's present position is that imposing additional restrictions on Regulation S offerings "would not directly impose additional burdens on companies, although [it] may [create] indirect costs."³⁵⁴ Perhaps such costs would be just intrusive enough, however, to frustrate the Regulation's purpose. Although it certainly was not the SEC's goal to facilitate foreigners' ability to make money by exploiting U.S. securities laws and the U.S. market, that effect could not have been completely unanticipated.

CONCLUSION

Regulation S is an important step by the SEC toward recognition of the increasing globalization of world financial markets. The Regulation not only provides U.S. issuers expanded access to multinational

registered under the Act or unless an exemption from registration is available; and

(3) Placement of a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities.

While taking these actions will establish the requisite reasonable care, it is not the exclusive method to demonstrate such care. Other actions of the issuer may satisfy this provision.

Id.

352. Problematic Practices, *supra* note 43, at 35,665 (requesting comments regarding costs and benefits associated with amending Reg. S).

353. See Cohen, *supra* note 4, at C1 (referring to short-selling as Reg. S loophole that SEC never intended).

354. Problematic Practices, *supra* note 43, at 35,665.

capital markets, but it reflects a new attitude toward the principles of comity and the legitimacy of foreign securities laws. Notwithstanding its shortcomings, the present Regulation S appears to have generally satisfied its objectives. For better or for worse, transactions can now be performed with both the certainty of a safe harbor and in accordance with streamlined procedures.

Unfortunately, speculators have learned how to exploit this financial resource, in obvious disregard for SEC intentions. Because short sales involving Reg. S issues are almost guaranteed to yield a profit, investors have an extraordinary incentive to engage in them. Such a guarantee, however, is likely only to cause the proliferation of short-selling. While currently there is little justification for actually *repealing* what most people view as a step in the right direction, it is time for the SEC to recognize and respond to the magnitude and consequences of Regulation S's misuses. If the SEC determines that U.S. markets and U.S. persons are conclusively disadvantaged by the exploitive practices, then it must amend the Regulation, according to the abovementioned proposal, to eliminate any safe harbor protection for resales of Reg. S securities into the United States. At a minimum, the SEC should increase the rate at which it initiates enforcement proceedings against those who "seek to evade the registration requirements of the [1933 Act] under the color of compliance with Regulation S."³⁵⁵

355. Problematic Practices, *supra* note 43, at 35,664.

