“PUSHING THE ENVELOPE”* OF THE REGULATION S SAFE HARBORS

JULIE L. KAPLAN**

TABLE OF CONTENTS

Introduction ........................................ 2496

I. Historical Context of Regulation S and the Extraterritorial Application of Section 5 ................. 2502
   A. Release 4708: The Predecessor .................. 2503
   B. Regulation S: The Genesis ...................... 2506

II. The General Structure of Regulation S ............ 2509
   A. Operative Definitions .......................... 2510
      1. “U.S. person” .................................. 2510
      2. Other definitions ............................. 2512
   B. General Statement (Non-Safe Harbor Approach) .. 2517
   C. General Conditions for Rule 903 and 904 Safe
      Harbors .......................................... 2518
   D. Issuer-Distributor Safe Harbor .................. 2521
      1. Category 1: offerings of foreign issuers, overseas
         directed offerings, and foreign government
         offerings ....................................... 2521


** J.D. Candidate, May 1996, The American University, Washington College of Law. This Comment is dedicated to the memory of my grandmother, Pearl Graham, who still inspires me to aim higher.

The author expresses her gratitude to Arthur C. Delibert, Esq. of Kirkpatrick & Lockhart for his assistance in unraveling many of the complex aspects of securities laws, as well as to Alan J. Berkeley, Esq. of Kirkpatrick & Lockhart for his general thoughts on the future of Regulation S. I am most appreciative of Robert H. Kluge III and Adam R. Waldman for their advice and comments on prior drafts of this Comment. Finally, I wish to extend special thanks to my parents, Gerald and Andrea Kaplan, for their absolute, continuous support.

2495
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).\(^4\)


\(^{3}\) 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)).

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 mails\(^10\) 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 purchasers\(^14\)—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 Cl (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 Cl.


\(^8\) Hazen, supra note 7, at 7.


\(^10\) 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).


\(^16\) 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. 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.

Regulation S is one such exemption from the registration requirements of section 5 of the 1933 Act. Essentially, Regulation S codified a series of rules that collectively adopt a "territorial" approach toward section 5. Specifically, if a securities transaction occurs within the United States, registration is required. If, however, the transaction takes place outside the United States, then no registration is necessary. Regulation S created two safe harbor provisions for offshore sales of unregistered securities: an issuer safe harbor and a resale safe harbor. These safe harbors enable some issuers to avoid legal consequences when they sell their securities offshore without U.S. registration. 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.

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. 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.
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);
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... interstate transportation or communication or of the mails" in connection with the offer or sale of unregistered securities. Id. Interstate transportation, or interstate...
the extraterritorial\textsuperscript{28} application of U.S. securities laws, the SEC recognized principles of comity\textsuperscript{29} and ultimately adopted a territorial approach to the registration requirements.\textsuperscript{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."\textsuperscript{31} Indeed, investors have raised a great

---

\textsuperscript{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 effect 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).

\textsuperscript{29} 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").

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

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. 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. 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. 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. 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. Essentially, the short-sellers borrowed Primerica stock from a broker and immediately sold it, hoping that the price would decline. 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 306-29 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. In response to initial reports of Reg. S's misuse and abuse, Congress recently expressed interest in revisiting, revising, and perhaps even repealing the 1933 Act exemption. 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.

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.

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 Walter Highlights Concern Over Application of Regulation S, 26 Sec. Reg. & L. Rep. (BNA) No. 10, at 366 (Mar. 11, 1994) [hereinafter SEC's Walter] (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 92, 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).
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. 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. 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." At the time Congress enacted the Securities Act of 1933, relatively few international securities offerings occurred. As a result, the immediate effect of the statute on global markets was unknown and untested. Accordingly, the scope of the 1933 Act tended to be interpreted literally and, therefore, very broadly. In practice, the

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. Because of the growing number of international offerings, however, the SEC found it necessary to formalize its opinion regarding the extraterritorial application of U.S. securities laws.

A. Release 4708: The Predecessor

Release 4708, promulgated in 1964, was the SEC's first attempt to define the extraterritorial reach of the 1933 Act's registration requirements. 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. COMMM'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-315. 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. 38-4708, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶¶ 1361-62 (July 9, 1984) [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. Reliance upon Release 4708, however, required that the distribution be effected in such a manner that the unregistered securities came to rest abroad.

Release 4708 attempted to define the reach of the section 5 registration requirements by setting out general standards for their application. 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. The SEC's position in Release 4708 of foregoing enforcement proceedings in certain instances remained consistent with the policy underlying section 5 "to protect American investors." 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

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.


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

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)).


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:

"If we regulate too much, we will lose the game because companies will... make 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... regulate 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 115-19. 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 occurs and subsequently allow U.S. investors to take advantage of global investments.

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. 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. The SEC accepts this so-called "mutual recognition" philosophy because it remains consistent with the SEC's goal of protecting U.S. investors purchasing securities in the secondary market. 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.


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.\footnote{15 U.S.C. \S 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).} 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.\footnote{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).}

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.\footnote{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).} 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.\footnote{82. See infra notes 288-329 and accompanying text (illustrating alleged abuses of Reg. S and recapitulating concept of short-selling).}

The regulation was initially proposed for comment on June 10, 1988\footnote{Offshore Offers and Sales, Securities Act Release No. 33-6779, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) \# 84,242, at 89,123 (June 10, 1988) [hereinafter Proposing Release].} and was revised and reproposed on July 11, 1989.\footnote{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].} Because of the opportunity for comment provided by the SEC,\footnote{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.} Regulation S as adopted on April 24, 1990\footnote{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).} had already resolved many problems that commentors identified.\footnote{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).} Unfortunately, until the Regulation was put to use and its practical effects understood, neither commentors nor the SEC could have predicted the abuses that have since resulted.
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.\(^9\) Regulation S, however, sets different limits on acceptable behavior.\(^9\) 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.\(^9\) The general precept is that these registration requirements do not pertain to offers and sales made outside the United States.\(^9\)2 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,\(^9\)3 Regulation S also protects from liability those persons relying on it in good faith.\(^9\)4 Because Regulation S is an agency rule adopted pursuant to the provisions of the Administrative Procedure Act\(^9\)5 and section 19(a) of the 1933 Act,\(^9\)6 it is binding authority.\(^9\)7 This authority differs

\(^9\) 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).

\(^9\) 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).

\(^9\) 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).

\(^9\)2 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.


\(^9\)4 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).


\(^9\)7 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" 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.


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 investor 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.

Regulation S also treats a trust or estate as a U.S. person if any trustee, executor, or administrator is a "U.S. person." 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." Moreover, a corporation's place of incorporation determines whether it is a U.S. person for the purposes of Regulation S. 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, unless incorporated and owned by "accredited investors."
2. Other definitions

Providing a detailed analysis of all of the definitions contained in Regulation S is beyond the scope of this Comment. 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 terms to which the SEC refers frequently throughout the various categories of the Regulation S safe harbor provisions. Although these terms are not used in the General Statement, they are helpful in construing it.

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. These factors reasonably reflect the amount of available information regarding such securities, as well as the likelihood that the securities will flow back into the United States.

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. The Regulation S Proposing Release 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).

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. While such factors are not included in Reg. S as adopted, 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. The SEC's paramount goal is to provide protection to U.S. investors. To achieve this end, the SEC mandates some form of public disclosure from securities issuers. 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. Accordingly, Regulation S's issuer safe harbor is comprised of three categories of securities, each subject to different restrictions. For issuers in Category 1, the tendency toward flowback is not troublesome because the issuers are reporting issuers under the 1934 Act. There is, therefore, sufficient information about the issuer available in the marketplace to ensure investor protection. Category 2 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 commentors, 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).
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, § 230.902(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.
130. Reg. S, supra note 1, § 230.903(c)(2); see also infra notes 202-11 and accompanying text (providing further explanation of Category 1 securities).
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 3 issuers are all non-reporting issuers. 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.

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. 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." Rule 902(n) applies different definitions of SUSMI to equity and to debt securities. 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.

---

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(1) (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 81 (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 of the 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. Alternatively, SUSMI exists if at least twenty percent of all trading in the equity securities occurred in the U.S. market 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.

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: (1) all debt securities and non-convertible capital stock not entitled to participate in residual earnings or assets of the issuer or certain asset-backed securities are held of record by at least 300 U.S. persons; (2) one billion dollars or more in principal amount of all debt securities in the aggregate is held of record by U.S. persons; and (3) twenty percent or more in principal amount of all debt securities is held of record by U.S. persons.

Defining an "overseas directed offering" (ODO) 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. 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; or (2) an offering of a domestic issuer's non-convertible debt securities offering directed at the residents of Britain, this offering would constitute an ODO.
securities 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. 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. 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 contravene both the objectives of the Regulation and the policies underlying the 1933 Act. Such an issuer cannot rely on the Regulation S safe harbor.

The definition of "distributor" includes any dealer, underwriter, or other person participating in the distribution of Reg. S securities pursuant to a contractual agreement. 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. 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).


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, § 230.905(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

---

162. 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 80,655 (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 80,655. 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. 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.

C. General Conditions for Rule 903 and 904 Safe Harbors

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

As defined in Rule 902(i), an "offshore transaction" is one in which an offer is made to a person who is outside the United States.
States and either (1) the buyer is, or is reasonably believed by the seller to be, outside the United States when the order originates, or (2) the transaction is executed on the trading floor of an established foreign securities exchange or through a designated offshore securities market (DOSM), provided that the seller does not know the transaction has been pre-arranged with a U.S. buyer. 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,” is defined in Rule 902(b). Directed selling efforts are any activities undertaken for the purpose of “conditioning” the U.S. market for securities being offered, or any activity that could reasonably be expected to do so. Marketing efforts designed and subsequently expected to stimulate U.S. interest in the securities being offered abroad are therefore prohibited.

---

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).
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).
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.
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. Rule 902(b), however, specifically provides exceptions to the definition of directed selling efforts. For example, marketing efforts in connection with the sale of securities in a private placement or Rule 144A restricted stock transaction are not usually treated as directed selling efforts for the purposes of Regulation S.

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. It
authorizes less restricted offerings than had previously been allowed without registration, notably relaxing prior practice in the offshore offering domain.\textsuperscript{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.\textsuperscript{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.\textsuperscript{197} In order to ensure that the securities "come to rest" abroad, the issuer-distributor safe harbor imposes certain procedural safeguards\textsuperscript{198} that vary depending upon the perceived risk of flowback into the United States.\textsuperscript{199} The procedural safeguards increase in number and stringency from Category 1 securities\textsuperscript{200} to Category 3 securities.\textsuperscript{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,\textsuperscript{202} securities offered and sold in ODOs,\textsuperscript{203} transactions involving securities backed by the full faith and credit of a foreign government,\textsuperscript{204} and securities offered and sold pursuant to employee benefit plans of the issuer or its affiliates.\textsuperscript{205} This category

\textsuperscript{195} Trachtman, \textit{supra} note 2, at 297 (recognizing significant liberalization in area of offshore offerings).

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

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

\textsuperscript{198} Adopting Release, \textit{supra} note 1, at 80,671. These procedural safeguards are, in essence, additional restrictions called offering restrictions and transactional restrictions. \textit{Id.}; cf. Wolff, \textit{supra} note 2, at 135 (acknowledging that phrases used in SEC releases are not used in Reg. S itself).

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

\textsuperscript{200} Reg. S, \textit{supra} note 1, § 230.903(c)(1).

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

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

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

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

\textsuperscript{205} Reg. S, \textit{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{209} While the definition of SUSMI differs for debt and equity,\textsuperscript{210} Category 1 securities either have no SUSMI or are ODOs that are directed to citizens or residents of a single national market.\textsuperscript{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)\textsuperscript{212} under the 1934 Act,\textsuperscript{213} foreign reporting issuers with SUSMI, and non-reporting foreign issuers issuing debt securities.\textsuperscript{214} Non-reporting foreign issuers offering non-participating preferred stock\textsuperscript{215} and asset-backed securities\textsuperscript{216} are also included in this

\textsuperscript{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).

\textsuperscript{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).

\textsuperscript{208} Adopting Release, supra note 1, at 80,673 n.85 (citing Preliminary Note 2).

\textsuperscript{209} See Release 4708, supra note 54, ¶ 1302 (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").

\textsuperscript{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).

\textsuperscript{211} Coogan & Kimbrough, supra note 24, at 5.

\textsuperscript{212} See supra note 130 (defining reporting issuer under 1934 Act).

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

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

\textsuperscript{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.\textsuperscript{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.\textsuperscript{218} Debt securities are included in this category not only because of the institutional nature of the debt market,\textsuperscript{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.\textsuperscript{220}

In addition to the general conditions imposed by Rule 903(a), the issuer-distributor safe harbor,\textsuperscript{221} securities in Category 2 are subject to two types of restrictions, referred to as "offering restrictions"\textsuperscript{222} and transactional restrictions.\textsuperscript{223} The consequences of failing to adhere to one restriction or the other are extremely different.\textsuperscript{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.\textsuperscript{225} Conversely, failure by any party to

\textsuperscript{216} See supra note 145 (providing definition of asset-backed security).

\textsuperscript{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).

\textsuperscript{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).

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

\textsuperscript{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).

\textsuperscript{221} Reg. S, supra note 1, § 230.903(a).

\textsuperscript{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).

\textsuperscript{223} Reg. S, supra note 1, § 230.903(c)(2)(iii), (iv).

\textsuperscript{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).

\textsuperscript{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 period be made according to the provisions of Regulation S, pursuant to the registration requirements of the 1933 Act or an exemption therefrom. 228 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. 229 All offering materials used during the restricted period in connection with the offer or sale of these securities must include this disclosure. 230

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, during a forty-day restricted period. 231 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. 232 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, § 230.909(c)(2)(iii), (iv), and § 230.909(c)(3)(ii)(A), (B), (iii)(A), (B), (iv).


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.


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.\textsuperscript{236} Significantly, Regulation S does not connect the restricted period with the completion of the securities distribution.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{241} These retail purchasers can rely on section 4(1) of the 1933 Act,\textsuperscript{242} which provides a registration exemption for transactions by anyone not an issuer, underwriter, or dealer.\textsuperscript{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 category\textsuperscript{244} is a residual one, available to any issuer who does not qualify for the other catego-

\textsuperscript{236} See Adopting Release, supra note 1, at 80,676 (affording no safe harbor protection to those offering and selling nominally to evade registration).
\textsuperscript{237} See Silverman & Braverman, supra note 55, at 182 (ceasing prior practice of linking restricted period with completion of distribution).
\textsuperscript{238} Silverman & Braverman, supra note 55, at 182.
\textsuperscript{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).
\textsuperscript{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.
\textsuperscript{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).
\textsuperscript{243} See Coogan & Kimbrough, supra note 24, at 6 (discussing retailer's reliance on § 4(1) exemption to sell during restricted period).
\textsuperscript{244} See Reg. S, supra note 1, § 230.903(c)(3) (describing safe harbor category).
ries.\textsuperscript{245} Technically, Category 3 applies to any issuer’s securities. The Category essentially codifies a practice originated under Release 4708,\textsuperscript{246} assigning the most rigorous restrictive procedures to Category 3’s constituent issuers. Regulation S does not drastically improve these procedures,\textsuperscript{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.\textsuperscript{248} Instead, Reg. S is likely to provide a greater comfort level for non-reporting issuers.\textsuperscript{249} These issuers can now rely on a safe harbor, as opposed to Release 4708’s enforcement position and companion no-action letters.\textsuperscript{250}

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

\begin{itemize}
\item \textsuperscript{245} Adopting Release, supra note 1, at 80,679 (including in Category 3 all securities not covered by prior two categories).
\item \textsuperscript{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).
\item \textsuperscript{247} See Coogan & Kimbrough, supra note 24, at 7 (arguing that procedures are not greatly improved).
\item \textsuperscript{248} See Adopting Release, supra note 1, at 80,679 (discussing reason for residual category’s restrictions).
\item \textsuperscript{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.
\item \textsuperscript{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.
\item \textsuperscript{251} See supra notes 176-93 and accompanying text (considering two general conditions applicable to all securities).
\item \textsuperscript{252} See supra notes 227-32 and accompanying text (reviewing Category 2 offering restrictions).
\item \textsuperscript{253} See Reg. S, supra note 1, § 230.903(c)(3)(i)-(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).
\item \textsuperscript{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.
The restricted period for debt offerings is forty days. This forty-day restriction is effected by the requirement that the securities be represented upon issuance by a temporary global security. Definitive securities cannot be disbursed until the forty-day restricted period lapses and the beneficial owner 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.

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. 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. Therefore, the restricted period for Category 3 equity securities is one year. The conditions further require purchasers to certify that they are neither U.S. persons nor purchasing on behalf of U.S. persons. Additionally, purchasers must agree to resell only in accordance with Regulation S provisions, registration, or an exemption therefrom. Domestic issuers' shares must contain a legend indicating that the security's transfer is proscribed unless done in accordance with Regulation S.

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


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).

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)).

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).

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 89,188. 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.


restrictions also require that the issuer decline registration of any securities transfer not done in accordance with the Regulation.\textsuperscript{267} If, however, foreign law prevents the issuer from refusing to register the transfer or if the securities are in bearer form, other reasonable procedures\textsuperscript{268} must be implemented.\textsuperscript{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.\textsuperscript{270}

E. Rule 904 Resale Safe Harbor

Rule 904 exempts some secondary market trading from the section 5 registration requirements.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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).\textsuperscript{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.\textsuperscript{275} Such persons may immediately avail themselves of this resale safe harbor simply by complying with the general conditions of Rule 904.\textsuperscript{276} If these

\begin{enumerate}
\item \textsuperscript{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. \textit{Id.}
\item \textsuperscript{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).
\item \textsuperscript{269} Reg. S, supra note 1, § 230.903(c)(3)(iii)(B)(4).
\item \textsuperscript{270} Reg. S, supra note 1, § 230.903(c)(3)(iv).
\item \textsuperscript{271} See Gibbons, supra note 30, at 376 (stating that certain secondary market trading in unregistered securities is exempt).
\item \textsuperscript{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).
\item \textsuperscript{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).
\item \textsuperscript{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).
\item \textsuperscript{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).
\item \textsuperscript{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. 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, and not because the affiliated person holds more than ten percent of the company's outstanding stock. In conjunction with the two general conditions, there is a requirement that no special selling compensation, other than the ordinary broker's commission, be paid in connection with the offer or sale.

2. Safe harbor for dealers

Resales by dealers prior to the end of the restricted period are subject to two additional conditions. First, neither the dealer nor any agent may knowingly offer or sell to a U.S. person during the restricted period. 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.

2. Safe harbor for dealers

Resales by dealers prior to the end of the restricted period are subject to two additional conditions. First, neither the dealer nor any agent may knowingly offer or sell to a U.S. person during the restricted period. 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.

...
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. 285

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 S 288 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 States 292 and engaging in offshore transactions solely to "wash" 293

285. 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).
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.
the restrictions off those securities in anticipation of their return to the U.S. market upon expiration of the restricted period. The intent of Reg. S, however, was for shares to be held overseas as long-term investments, 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.

What Regulation S did intend was to allow and encourage domestic issuers to compete in global markets. 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 restrictions 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.

---

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 (adopter 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 companies and a means of raising money quickly for those that are loss-ridden. Issuers can perform a Reg. S offering quickly 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. 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 discount from the issuer’s current stock price in the U.S. markets.

The availability of discounted Regulation S shares has prompted investors to engage in “short sales.” 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.” Such sales are generated because the seller anticipates a decline in a security’s price and seeks to profit from the decline. 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. 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).


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 benefiting 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 PESSION & 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).


308. PESSION & ROSS, supra note 25, at 646.

309. PESSION & 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 G1. 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).\textsuperscript{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.\textsuperscript{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."\textsuperscript{325} In fact, as recently as April 1994, Representative Edward Markey (D.}

\textsuperscript{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).

\textsuperscript{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 1253 (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 1052 (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 1052, 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 1953 Act § 5 registration provisions and the 1954 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 136678, 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.

\textsuperscript{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.\textsuperscript{326} Because of several press reports alleging widespread abuses of Reg. S,\textsuperscript{327} the SEC stated that it is monitoring the situation carefully.\textsuperscript{328} Despite such oversight, however, to date the SEC has brought few enforcement proceedings for abuse of Regulation S.\textsuperscript{329}

IV. RECOMMENDATIONS

Both issuers and investors are manipulating the registration exemption that Regulation S provides.\textsuperscript{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,\textsuperscript{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

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

\textsuperscript{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).

\textsuperscript{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).

\textsuperscript{329} See supra note 324 (summarizing only enforcement action brought by SEC to date).

\textsuperscript{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).

\textsuperscript{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. 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 securities 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 distributor 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)(9).

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, who buy securities with a "view to distribute," and bring enforcement actions against them for violating section 5. There would be no "good faith" defense available to such individuals, as there may be if such persons were not treated as distributors.

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, 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. 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 144 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 belief that once the forty-day restricted period of the safe harbors has been satisfied, the securities can be resold into the United States


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).


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."\footnote{341}{SEC Will Revisit, supra note 239, at 1 (quoting SEC Commissioner Roberts).} Although such a proposal may appear to be a rather "draconian alternative,"\footnote{342}{See SEC Will Revisit, supra note 239, at 2 (characterizing idea of treating Reg. S securities as restricted securities as "draconian").} 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 simple\footnote{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.} and is not costly. The security's transfer agent\footnote{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.} 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.\footnote{345}{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.} 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.\footnote{346}{15 U.S.C. § 2(11) (1994).} 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.\footnote{347}{Reg. D, supra note 339, § 230.502(d).}

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
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. Others, like Primerica, would likely still do Reg. S offerings because they are both "efficient and effective."  

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. 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, which requires the issuer

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 offerings 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 loophole 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.”

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. at 35,665.


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

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
