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INVESTING ABROAD: REGULATION S AND U.S. RETAIL INVESTMENT IN FOREIGN SECURITIES

S. ERIC WANG

I. INTRODUCTION	330
II. SUMMARY OF REGULATION S	332
A. <i>The History Behind and Purposes of Regulation S</i>	333
B. <i>Regulation S</i>	335
1. OFFSHORE TRANSACTIONS AND DIRECTED SELLING EFFORTS	336
2. THREE CATEGORIES	338
III. A CLOSE READING OF REGULATION S AND ITS UNDERLYING POLICIES	342
A. <i>Regulation S</i>	343
B. <i>Sections 4(3) and 4(4)</i>	345
C. <i>Rule 15a-6</i>	349
D. <i>Contacts and Solicitation</i>	351
E. <i>Goals and Theories of Regulation S</i>	358
1. CONSISTENCY WITH THE GOALS OF REGULATION S ..	358
2. EXCEPTION 1: RESIDENCY STANDARD	362
3. EXCEPTION 2: NOMINEE ENTITIES	363
a. <i>Analysis of Regulation S and Nominee Entities</i>	363
b. <i>The Commission's Recent Announcements on Nominee Entities</i>	366
IV. PERSPECTIVES AND PRACTICES ON THE GROUND	369
A. <i>Interviews</i>	369
B. <i>Market Practices</i>	370
C. <i>A View From the Financial Institutions</i>	371
D. <i>Analysis of an Electronic Exchange</i>	373
E. <i>Case-Study of an Issuer</i>	376
1. T SHARES	377
2. DECISION NOT TO REGISTER P SHARES	379
3. U.S. PARTICIPATION IN THE OFFERING	379
4. REGULATION S AND ITS POLICIES	381
a. <i>Application of Regulation S</i>	381
b. <i>Goals and Effects of Regulation S</i>	383
V. CONCLUSION	385
Appendix A	389
Exhibit 1	390
Exhibit 2	391

I. INTRODUCTION

Recent discussions about implementing a competitive regulatory securities regime in the United States have raised questions about the efficiency of the present regulatory structure.¹ Specifically, proponents of regulatory competition believe that competition will bring about a more efficient set of regulations. Broadly speaking, the theory is that businesses will raise capital under regulatory regimes that present the lowest cost of capital, and investors will flock to regimes that provide them with the greatest returns on their investments. In this way, the most efficient regimes would be identified. Of course, under the present set of regimes, there is already some regulatory competition between countries as capital moves from one country to another.² The proposals for regulatory competition hope to make these international capital flows more efficient.³ The present regulations governing such investment movement out of the United States is the subject of this article. In particular, the article focuses on U.S. securities laws that may inhibit the movement of U.S. non-institutional (retail) investors to foreign markets.⁴

This article examines the restrictions that Regulation S of the 1933 Securities Act (the "Securities Act") places on U.S. investors wishing to purchase foreign securities. Regulation S is the primary set of rules promulgated by the Securities Exchange Commission (the "Commission") to regulate U.S. investment in foreign securities. In particular, this article focuses on what are termed "Category 1 securities," which are explained in detail in Part II. The article also considers restrictions on purchases of foreign securities imposed by other facets of the Securities Act and of the 1934 Securities Exchange Act (the "Exchange Act"). The article isolates Section 4(3) of the Securities Act and Rule 15a-6 of the Exchange Act for

¹ See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998); Howell Jackson & Eric Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999 - Part 1*, 56 BUS. LAW. 653 (2001).

² See Choi & Guzman, *supra* note 1, at 906; Joseph F. Jacob, *The Impact of the Euro on the United States Equity Markets*, 13 ST. JOHN'S J. LEGAL COMMENT 399 (1998).

³ See Choi & Guzman, *supra* note 1, at 906; Romano, *supra* note 1, at 2418.

⁴ This article does not discuss laws that inhibit the movement of U.S. issuers to such other markets and leaves that problem to future research. As a starting point though, one would think about any barriers to U.S. issuers that result from the restrictions imposed by Category 3 status. For example, one would have to consider any markets on which U.S. securities could not be traded because of U.S. Category 3 restrictions. Category 3 of Regulation S is explained in Part II of this article.

analysis and discussion. Furthermore, the article studies whether or not the restrictions found are followed in the market and the effects of these restrictions on the market.

The article concludes that the main impediments to U.S. retail investment abroad are the restrictions U.S. securities laws place on advertisement and solicitation. This result is accurately reflected in the market by the fact that U.S. brokers are able to purchase foreign securities abroad for U.S. retail investors with little difficulty. This is in accordance with the theoretical underpinnings of Regulation S. Under the theory of Regulation S, U.S. retail investors, isolated from solicitation by foreign issuers and brokers, are unaware of foreign opportunities; therefore, they will not invest in foreign securities. While the analysis in this article reveals a number of statutory difficulties and the market evidence unearths a couple of surprising results, Regulation S, in general, appears, at the present time, to be effective.

Since the literature on regulatory competition frames the subject of this article, a brief review of literature is in order. In 1998, Professor Roberta Romano set forth a proposal that would permit each state to promulgate its own regulatory regime, and would allow companies the choice of the regime by which it would be governed.⁵ Professor Romano believes that, under such a system, companies and investors would flock to the most efficient regulatory regimes.⁶ Professor Romano also advances an extension of this theory into the arena of foreign securities by opening up U.S. markets to foreign issuers who abide by a foreign regulatory regime.⁷ In theory, this competition between regulatory regimes would force the U.S. system to become more efficient.⁸ Professors Stephen Choi and Andrew Guzman propose a similar solution, which they call "portable reciprocity."⁹ Portable reciprocity would allow issuers to pick the international regulatory regime of their choice and trade their securities on any market in the world.¹⁰ Such proposals would truly allow the flow of capital globally, even beyond the capital flow already seen today.

Professor Howell Jackson and his co-author, Eric Pan, however, have found evidence in the European market that appears counter to the expected

⁵ Romano, *supra* note 1, at 2362.

⁶ *Id.* at 2428.

⁷ *Id.* at 2419-20.

⁸ *Id.* Indeed, according to Professor Hal Scott, "[t]he fact that the international unregulated private placement market does not always demand [U.S.] public market documentation reveals that the level of disclosure required by the United States is not optimal." Hal S. Scott, *Internationalization of Primary Public Securities Markets*, 63 LAW & CONTEMP. PROBS. 71, 73 (Summer 2000).

⁹ Choi & Guzman, *supra* note 1, at 903.

¹⁰ *Id.* at 907.

effects of regulatory competition.¹¹ Professor Jackson and Mr. Pan studied European markets, where a form of regulatory competition “analogous to what proponents of issuer choice are recommending for the United States” already exists.¹² They find that few issuers are registering in foreign jurisdictions; most issuers prefer to focus the international aspects of their offerings on institutional investors.¹³ The reason for this, according to Professor Jackson and Mr. Pan’s data, is that secondary market linkages allow retail investors from all over Europe to purchase in the home market of the issuer.¹⁴ Therefore, issuers have little incentive to list on markets outside of their home jurisdictions.¹⁵ Furthermore, according to Professor Jackson and Mr. Pan, many of the international components of European offerings in question include a Rule 144A component.¹⁶ Thus, U.S. institutional investors have been able to participate in this market as well. The extent of U.S. retail participation in this market is unclear, and that, of course, is the subject of this article.¹⁷

The following parts analyze the rules surrounding U.S. retail purchases of foreign securities. The background and basic functions of Regulation S are discussed in Part II. Part III examines the details of how this regulation controls U.S. activity abroad and addresses analytical problems that arise. Furthermore, Part III puts Regulation S in context through a discussion of Section 4(3) of the Securities Act and Rule 15a-6 of the Exchange Act. Part IV samples market compliance with and understanding of the restrictions presented in Part III; Part V concludes.

II. SUMMARY OF REGULATION S

This section briefly discusses the history of and purposes for enacting Regulation S. It then provides a brief summary of the statute for those who are unfamiliar with this aspect of the U.S. securities laws.

¹¹ Jackson & Pan, *supra* note 1, at 653.

¹² *Id.* at 661.

¹³ *Id.* at 654-55.

¹⁴ *Id.* at 655.

¹⁵ *Id.*

¹⁶ *Id.* at 681.

¹⁷ Regulation S has been viewed by some “as a type of capital control, restricting the flow of [U.S.] investor funds to foreign markets.” Scott, *supra* note 8, at 100. This article concludes, however, that any restriction on capital flow results from prohibitions against advertisement and solicitation.

A. *The History Behind and Purposes of Regulation S*

Regulation S was first proposed in 1988 to clarify the Commission's position with respect to the growing flow of international capital.¹⁸ Specifically, the Commission sought to build upon the philosophy expounded in its Release No. 4708, which concerned the distribution of U.S. securities abroad.¹⁹ In 1990, the Commission finalized Regulation S as a safe harbor for distributions of securities made in foreign countries by both foreign and domestic companies.²⁰ In 1998, however, Regulation S was substantially modified to prevent U.S. companies from taking advantage of the Regulation S safe harbor and making unregistered distributions into the United States.²¹

A Presidential Task Force charged with increasing foreign investment in U.S. corporations spurred the Commission's initial foray into standard setting in international waters.²² The Task Force recommended that the Commission issue a release clarifying the reach of the Securities Act with respect to U.S. securities aimed at foreign investors.²³ In addressing these securities, the Commission stated the principle that the Securities Act did not reach unregistered securities whose "distribution is . . . effected in a manner which will result in the securities coming to rest abroad."²⁴ In the

¹⁸ Offshore Offers and Sales, Exchange Act Release No. 33-6779 (June 17, 1988).

¹⁹ *Id.*

²⁰ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990). Regulation S was repropoed in 1989 to incorporate a number of changes that stemmed from comment letters following the Commission's 1988 proposal. Offshore Offers and Sales, Exchange Act Release No. 33-6838 (July 11, 1989).

²¹ Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998). Regulation S was modified substantively on one other occasion for the purpose of facilitating U.S. press access to the press conferences of companies making unregistered distributions. Offshore Press Conferences, Meetings with Company Representatives Conducted Offshore and Press-Related Materials Released Offshore, Exchange Act Release Nos. 33-7470, 34-39227 (Oct. 17, 1997). *See also* Offshore Press Conferences, Meetings with Company Representatives Conducted Offshore and Press-Related Materials Released Offshore, Exchange Act Release Nos. 33-7356, 34-37803 (Oct. 18, 1996).

²² The Presidential Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United States Corporations Operating Abroad was appointed in October, 1963, as part of an effort to decrease the U.S. balance of payments deficit and to protect U.S. gold reserves. Registration of Foreign Offerings by Domestic Issuers; Registration of Underwriters of Foreign Offerings as Broker-Dealers, Exchange Act Release Nos. 33-4708, 34-7366 (July 9, 1964).

²³ *Id.*

²⁴ *Id.* At this time, the Commission focused on whether or not distributions targeted U.S. nationals. *See id.*

years that followed this release, the Commission expanded the scope of the principle to foreign issuers distributing abroad as well.²⁵

In the years following Release No. 4708, global capital markets underwent tremendous growth. From 1976 to 1986, the "international bond market grew at a compound annual rate of 21%."²⁶ Similarly, "Euroequity offerings of common and preferred stock amounted to approximately \$20 billion in 1987 compared to only about \$200 million" in 1983.²⁷ Investors from around the world participated in this growth. In 1987, U.S. investors' "purchases and sales of foreign stocks reached a record \$187 billion," and "foreign investors' activity in [U.S.] domestic corporate stock was a record \$481.5 billion."²⁸ During this period, the Commission issued numerous no-action letters to clarify its position concerning offshore offerings and participation by U.S. investors.²⁹ In the face of such growth, however, the Commission undertook to construct a new set of regulations, known as Regulation S.

The Commission built Regulation S "based on a territorial approach" to securities regulation.³⁰ After all, the Securities Act was designed to protect U.S. securities markets and not foreign markets. Furthermore, principles of comity dictated that the Commission "recognize[] the primacy of the laws in which a market is located."³¹ With this understanding, the Commission built Regulation S on three propositions. The first was the principle of comity and the recognition that offerings of foreign issuers with no substantial U.S. market interest would not have any effect on U.S. markets.³² The second proposition was to "ensure against an indirect distribution in the [U.S.] markets."³³ Third, the Commission believed that "periodic reporting under the Exchange Act [could] be relied upon for the protection of investors once the marketing effort ha[d] been completed."³⁴

²⁵ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

²⁶ Offshore Offers and Sales, Exchange Act Release No. 33-6779 (June 17, 1988).

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

See also Offshore Offers and Sales, Exchange Act Release No. 33-6779 (June 17, 1988). Professor Scott, however, believes that Regulation S does not follow the territorial principle "because it restricts participation of [U.S.] investors in offshore primary markets." Scott, *supra* note 8 at 71, 100. How and if Regulation S does this is the subject of this article.

³¹ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

See also Offshore Offers and Sales, Exchange Act Release No. 33-6779 (June 17, 1988).

³² Offshore Offers and Sales, Exchange Act Release No. 33-6779 (June 17, 1988).

³³ *Id.*

³⁴ *Id.*

In 1998, the Commission amended Regulation S to curb abuses by U.S. corporations. The second proposition upon which the Commission had based Regulation S had been violated. United States corporations were making indirect distributions into the United States while bypassing the registration requirements through the safe harbor of Regulation S. The details of this amendment will be discussed below following a detailed discussion of the rules of Regulation S.

Interestingly, the Commission only amended Regulation S with respect to U.S. corporations and not with respect to foreign issuers.³⁵ There was little evidence of any abuse of Regulation S by foreign issuers, and commentators on the proposed rules strongly objected to extending the amendments to foreign issuers.³⁶ Their objections were grounded in the difficulties that would be imposed upon foreign issuers by the change in rules and the possible "strong disincentive for foreign companies to list their securities on [U.S.] markets."³⁷

B. Regulation S

Regulation S provides a safe harbor for issuers making distributions outside of the United States. The general statement of the safe harbor is found in Rule 901 and excludes "offers and sales that occur outside the United States" from the reach of Section 5 of the Securities Act.³⁸ A transaction is deemed to occur outside the United States when it meets certain requirements.³⁹ Rules 903 and 904 lay out these requirements. Rule 903 pertains to primary distributions by issuers, distributors, and other persons acting on their behalf.⁴⁰ Rule 904 applies to resales made by persons not covered under Rule 903.⁴¹ There are two global requirements for falling within the safe-harbor, and they are, of course, incorporated into both Rules 903 and 904. The two global requirements are that the transaction must be offshore and that no directed selling efforts be made into the United States.⁴² The remaining requirements for falling within the Regulation S safe harbor depend upon the nature of the securities being offered. The securities are

³⁵ Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998).

³⁶ *Id.*

³⁷ *Id.*

³⁸ Commodity and Securities Exchanges, 17 C.F.R. § 230.901 (2002).

³⁹ If a sale or offer can be demonstrated to have been made outside of the United States, § 5 of the Securities Act will not apply regardless of whether or not the requirements of Regulation S have been met. Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

⁴⁰ Commodity and Securities Exchanges, 17 C.F.R. § 230.903(a) (2002).

⁴¹ *Id.* at § 230.904(a).

⁴² *Id.* at § 230.903-4.

divided into three categories, each with its own set of restrictions.⁴³ These categories are all defined in Rule 903, but the restrictions placed on each category are different depending on whether a transaction is a primary offering under Rule 903 or a resale under Rule 904.

1. OFFSHORE TRANSACTIONS AND DIRECTED SELLING EFFORTS

Both offerings and resales must meet the offshore transaction requirement in order to be deemed to have occurred outside of the United States.⁴⁴ For a transaction to be considered offshore, the offer must not be made to a person inside the United States.⁴⁵ Specifically, when the buy order is originated, the buyer must be physically outside the United States, or the seller must reasonably believe that the buyer is outside the United States.⁴⁶ Instead of researching the location of the buyer, sellers may opt for the alternative of executing an offering transaction "through a physical trading floor of an established foreign securities exchange."⁴⁷ In the case of resales, the seller may execute the transaction through any "designated offshore securities market."⁴⁸ In both of these situations, the location of the buyer does not matter.⁴⁹

As stated above, unless the transaction occurs on the physical trading floor of an established securities exchange or on a designated offshore securities market, the buyer must be outside the United States for a transaction to qualify as an offshore transaction under Rule 902(h). The Commission has stated that in the event of a "buyer [who] is a corporation or partnership, . . . an authorized employee [may] place[] the buy order while abroad" and satisfy the offshore transaction requirement.⁵⁰ This should be contrasted with the definition of U.S. person in Rule 902(k). U.S. persons are defined to include any "natural person," regardless of

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.* at § 230.902(h)(1)(i).

⁴⁶ *Id.* at § 230.902(h)(1)(ii).

⁴⁷ *Id.*

⁴⁸ *Id.* The SEC has the power to designate such offshore securities markets. *Id.* at § 230.902(b)(2). Recently, the Berlin Stock Exchange and the Korea Stock Exchange have joined the list of designated offshore securities markets. Berlin Stock Exchange, SEC No-Action Letter, 2000 SEC No-Act. LEXIS 902 (Sept. 26, 2000) and Korea Stock Exchange, SEC No-Action Letter, 2000 SEC No-Act. LEXIS 849 (Sept. 11, 2000).

⁴⁹ Commodity and Securities Exchanges, 17 C.F.R. § 230.902(h)(1)(ii) (2002).

⁵⁰ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

See also EDWARD F. GREENE, ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVE MARKETS §§ 5.02-5.03, 5-08 to 5-09 (5th ed. 2000).

citizenship, "resident in the United States" and any "corporation organized or incorporated under the laws of the United States."⁵¹ Since the present restriction does not utilize the term *U.S. person*, a domestic corporate entity that falls within the Rule 902(k) definition of U.S. person would appear to be allowed to purchase in an offshore transaction so long as its authorized employee places the order abroad. The definition of U.S. person is not used in this context but, instead, in other contexts including that of the distribution compliance period imposed on Category 2 and Category 3 securities discussed below.

To be considered a transaction outside of the United States under Rule 901, the transaction also must not be accompanied by any directed selling efforts into the United States.⁵² Directed selling efforts is defined as anything that "could reasonably be expected to have the effect of" or the purpose of "conditioning the market in the United States" for the offered securities.⁵³ This includes advertising in publications generally circulated in the United States.⁵⁴ There are specific circulation numbers for defining such publications, and tombstone advertisements are permitted to be printed in some globally circulated publications provided that less than 20% of the circulation is in the United States and that other maximum information requirements are met.⁵⁵

Aside from these traditional modes of targeting investors, the Commission has also promulgated guidelines for offerings made on the Internet.⁵⁶ Foreign issuers should include a prominent disclaimer on their web site that the offering is not intended for people in the United States. General disclaimers about the offer only being valid in places where it would be legal are insufficient, and the disclaimer "must be on the same screen as the offering material" or "be viewed before a person can view the offering materials."⁵⁷ Furthermore, the issuer has to implement "procedures that are reasonably designed to guard against sales to [U.S.] persons in the offshore

⁵¹ Commodity and Securities Exchanges, 17 C.F.R. § 230.902(k)(ii) (2002). See also Greene, et al., *supra* note 50, at §§ 5.02-5.03, 5-17.

⁵² Commodity and Securities Exchanges, 17 C.F.R. § 230.903-4 (2002).

⁵³ *Id.* at § 230.902(c)(1).

⁵⁴ *Id.*

⁵⁵ *Id.* at § 230.902(c)(2)-(3). Section 902(c)(3)(iii)(C) restricts the amount of information that may be printed on a tombstone advertisement. Acts permitted by the provisions on directed selling efforts are further detailed in Part III(D) of this article in conjunction with other regulations pertaining to solicitation.

⁵⁶ Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore, Exchange Act Release Nos. 33-7516, 34-39779 (Mar. 23, 1998).

⁵⁷ *Id.*

offering.⁵⁸ United States issuers must take more stringent safeguards because of the strong possibility of flowback, the heightened expectation by investors that U.S. laws will apply, and the substantial contacts that such issuers have to the United States.⁵⁹ The Commission advises U.S. issuers to include “password-type procedures . . . designed to ensure that only non-[U.S.] persons can obtain access to the offer.”⁶⁰

2. THREE CATEGORIES

Regulation S divides securities into three categories, each with a different set of requirements for both offerings and resales.⁶¹ Category 1 is the most lenient and imposes no further restrictions than the two global requirements just discussed.⁶² There are four ways securities can qualify for Category 1 status. First, securities are considered Category 1 securities if they are issued by a foreign issuer that “reasonably believes at the commencement of the offering” that there is “no substantial [U.S.] market interest” in those securities.⁶³ Substantial U.S. market interest is defined, for equity securities, by trading volume in the United States and, for debt securities, by holders of record who are U.S. persons.⁶⁴ Second, securities of a foreign issuer and non-convertible debt securities of a domestic issuer are Category 1 securities if they are directed into “a single country other than the United States” and made according to “the local laws and customary practices and documentation of such country.”⁶⁵ Third, securities “backed by the full faith and credit of a foreign government” are Category 1 securities.⁶⁶ Finally, securities that are “offered and sold to employees of the issuer . . . pursuant to an employee benefit plan” that meets certain requirements limiting the distribution to employees are Category 1 securities.⁶⁷

Category 2 securities have more restrictions than Category 1 securities. Securities that are eligible for Category 2 status are equity securities of a

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.* Internet solicitation is discussed further in Part III(D) of this article.

⁶¹ While the three groupings were always a part of Regulation S, the SEC officially adopted the captions of “Category 1,” “Category 2,” and “Category 3” as part of the 1998 amendments. Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998).

⁶² Commodity and Securities Exchanges, 17 C.F.R. § 230.903-4 (2002).

⁶³ *Id.* at § 230.903(b)(1)(i).

⁶⁴ *Id.* at § 230.902(j). This is also an example of the use of the term U.S. person as defined in § 230.902(k).

⁶⁵ *Id.* at § 230.903(b)(1)(ii).

⁶⁶ *Id.* at § 230.903(b)(1)(iii).

⁶⁷ *Id.* at § 230.903(b)(1)(iv).

reporting foreign issuer, debt securities of a reporting issuer, and debt securities of a non-reporting foreign issuer.⁶⁸

In addition to the global requirements discussed above, issuers of Category 2 securities must agree in writing to abide by both Rules 903 and 904. Furthermore, all offering materials must contain statements "to the effect that the securities have not been registered under the [Securities] Act and may not be offered or sold in the United States or to [U.S.] persons."⁶⁹ Such statements must appear in highly visible places such as the cover of the prospectus or offering circular.⁷⁰

Category 2 securities are also subject to a forty-day distribution compliance period.⁷¹ The distribution compliance period begins upon the closing of the offering or upon the first offering of securities to "persons other than distributors," whichever is later.⁷² During this forty-day compliance period, Category 2 securities are not to be sold to U.S. persons regardless of reasonable belief on the part of the seller.⁷³ In the case of resales, however, dealers are allowed to sell to U.S. persons so long as they do not know that the offeree or buyer is a U.S. person.⁷⁴ During the distribution compliance period, a distributor who sells Category 2 securities to another distributor or dealer must notify the purchaser that these restrictions also apply to the purchaser.⁷⁵

Category 3 securities carry the most stringent restrictions. Category 3 securities include any securities that are not eligible for Categories 1 and 2.⁷⁶ This means equity offerings of non-reporting foreign issuers where there is a substantial U.S. market interest in the securities offered, debt offerings of non-reporting U.S. issuers, and equity offerings of all U.S. issuers. As a practical matter, "[v]ery few, if any, offerings of foreign issuers will fall into this category."⁷⁷

As with both of the other categories, the transactions involving Category 3 securities must be offshore, and there must be no directed selling efforts.⁷⁸

⁶⁸ *Id.* at § 230.903(b)(2).

⁶⁹ *Id.* at Rule 903(b)(2); § 230.902(g)(2).

⁷⁰ *Id.* at § 230.903(b)(2); *Id.* at § 230.902(g).

⁷¹ Commodity and Securities Exchanges, 17 C.F.R. § 230.903(b)(2) (2002).

⁷² *Id.* at § 230.902(f).

⁷³ *Id.* at § 230.903(b)(2).

⁷⁴ *Id.* at § 230.904(b). As noted above, in this context, the restriction is against selling to U.S. persons as defined in § 230.902(k), and sales to offshore authorized employees of U.S. corporations are not exempt.

⁷⁵ *Id.* at § 230.903(b)(2).

⁷⁶ *Id.* at § 230.903(b)(3).

⁷⁷ Greene, et al., *supra* note 50, at §§ 5.02, 5-18.

⁷⁸ Commodity and Securities Exchanges, 17 C.F.R. § 230.903(a) (2002); Commodity and

In addition, as with Category 2 securities, issuers of Category 3 securities must agree in writing to abide by Rules 903 and 904 and print cautionary statements against offers and sales to U.S. persons on all offering materials.⁷⁹ Category 3 debt securities are subject to a forty-day distribution compliance period while Category 3 equity securities are subject to a one-year distribution compliance period.⁸⁰

During this distribution compliance period, securities are not to be sold to U.S. persons regardless of reasonable belief, but as with Category 2 securities, dealers who resell are allowed to resell to U.S. persons so long as they have no knowledge that the purchasers are U.S. persons.⁸¹ Furthermore, during the distribution compliance period, purchasers of securities must certify that they are not U.S. persons and agree to resell Category 3 securities "only in accordance with the provisions of . . . Regulation S."⁸² Additionally, issuers of Category 3 securities must, "either by contract or a provision in its bylaws, articles, [or] charter . . . refuse to register any transfer of securities not made in accordance" with Regulation S or the Securities Act.⁸³ Any distributor who sells Category 3 securities to another distributor or dealer within the compliance period must notify that purchaser that the purchaser is also subject to the restrictions of Regulation S.⁸⁴ Securities of domestic issuers must bear a legend stating that transfers must be made in accordance to Regulation S and that hedging transactions are not to be conducted.⁸⁵ Debt securities must be represented by a global security until the end of the compliance period and, at that time, exchanged for definitive securities only after certifications are made that the transaction does not violate Regulation S.⁸⁶

In 1998, equity securities of domestic reporting issuers were moved from Category 2 to Category 3 because of abuses by domestic corporations.⁸⁷ The Commission found that a number of domestic reporting issuers were

Securities Exchanges, 17 C.F.R. § 230.904(a) (2002).

⁷⁹ Commodity and Securities Exchanges, 17 C.F.R. § 230.903(b)(3) (2002); Commodity and Securities Exchanges, 17 C.F.R. § 230.902(g) (2002).

⁸⁰ Commodity and Securities Exchanges, 17 C.F.R. § 230.903(b)(3) (2002).

⁸¹ *Id.* at § 230.903(b)(3) and § 230.904(b). Again, in this context, the restriction applies to U.S. persons as defined in § 230.902(k).

⁸² Commodity and Securities Exchanges, 17 C.F.R. § 230.903(b)(3) (2002).

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.* For issuers whose securities are uncertificated, this requirement may be satisfied "by any means which puts holders and subsequent purchasers on notice of the applicable resale restrictions." Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998).

⁸⁶ Commodity and Securities Exchanges, 17 C.F.R. § 230.903(b)(3) (2002).

⁸⁷ Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998).

parking equity securities with offshore affiliates who then sold the securities into the United States after the forty-day distribution compliance period.⁸⁸ The proceeds from the U.S. sales were sent to the issuer.⁸⁹ Such schemes generally involved the use of non-recourse notes, recourse notes issued by entities with minimal or no assets, steep discounts on the price of the securities, and/or hedging transactions such as short-selling and option writing.⁹⁰

In order to curb such abuses, the Commission made a number of amendments to Regulation S. First, the Commission moved the equity securities of domestic reporting companies from Category 2 to Category 3 and lengthened the distribution compliance period for equity securities of domestic companies from forty days to one year.⁹¹ The longer period is intended to prevent sales of such securities back into the United States.⁹² The Commission also amended the rules so purchasers of equity securities of domestic issuers are not allowed to engage in hedging transactions with respect to those securities during the distribution compliance period.⁹³ The Commission also made equity securities of all domestic corporations "restricted securities" under the definition of Rule 144.⁹⁴ In so doing, the Commission hoped to "provide . . . clear guidance regarding when and how [such Regulation S] securities may be resold in the United States."⁹⁵ United States equity securities, then, "may be resold, after the expiration of the one-year distribution compliance period, to a [U.S.] person in reliance on the safe harbor provided by Rule 144, which allows . . . unlimited resales by non-affiliates" of the issuer two years after the distribution.⁹⁶ Furthermore, the Commission clarified that resales under Rule 904 could not wash off the restricted status of such securities.⁹⁷

⁸⁸ Problematic Practices Under Regulation S, Exchange Act Release No. 33-7190 (July 10, 1995).

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998).

⁹² *Id.* As stated above, this move only applied to domestic issuers and not to foreign issuers.

⁹³ Commodity and Securities Exchanges, 17 C.F.R. § 230.902(g)(1)(ii) (2002).

⁹⁴ *Id.* at § 230.905.

⁹⁵ Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998).

⁹⁶ Greene, et al., *supra* note 50, at §§ 5.02-03, 5-25.

⁹⁷ Commodity and Securities Exchanges, 17 C.F.R. § 230.905 (2002). *See also*, Offshore Offers and Sales, Exchange Act Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998). Incidentally, Category 2 securities are not considered restricted, so there are no restrictions to wash off.

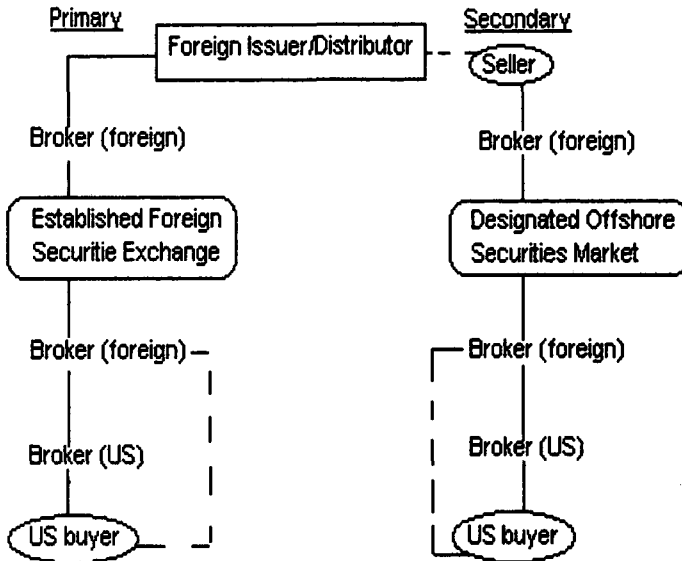
III. A CLOSE READING OF REGULATION S AND ITS UNDERLYING POLICIES

Under the Securities Act, there are only two possible sources of restrictions on U.S. investors purchasing Category 1 securities. The first is Regulation S itself, and the second is Section 4(3) of the Securities Act. Under Regulation S, U.S. residents who wish to purchase Category 1 securities must do so either through the physical trading floor of an established foreign securities exchange or on a designated foreign securities market.⁹⁸ In addition, Section 4(3) of the Securities Act may impose a forty-day waiting period on U.S. residents unless the U.S. residents' brokers can qualify for a Section 4(4) exemption under the Securities Act. How these brokers may qualify for a Section 4(4) exemption is not clear, but the policy rationale underlying the Commission's use of separate categorizations seems to support the application of Section 4(4) to such situations. Furthermore, Rule 15a-6 of the Exchange Act may force U.S. residents to trade through registered brokers, thereby giving the Commission some control over U.S. trading of Category 1 securities. A closer examination of this rule, however, appears to indicate that such is often not the case.

Figure 1, below, diagrams the transactions that will concern this section. On the left, the column is labeled "Primary" to indicate a primary market transaction in which a U.S. investor purchases Category 1 securities directly during the offering. The column on the right depicts a resale transaction where an U.S. investor purchases from another securities holder. The dotted line between "Foreign Issuer/Distributor" and "Seller" indicates that the seller in a resale may have bought the securities as part of the primary offering. The dotted lines leading from "Broker (foreign)" to "U.S. buyer" indicate that U.S. residents may contact foreign brokers directly. In most circumstances, however, U.S. residents wishing to purchase a foreign security will contact a U.S. broker, and the U.S. broker will contact a foreign broker to execute the transaction on a foreign exchange. The foreign broker often may be an affiliate of the U.S. broker. The foreign broker or affiliate represents a necessary step because, in most instances, only foreign entities have seats on, or are members of, the foreign exchange.

⁹⁸ References to "U.S. resident," unless otherwise noted, refer to retail investors located in the United States.

Figure 1.



A. Regulation S

Under Rules 902, 903, and 904 of Regulation S, U.S. residents may only purchase securities on the “trading floor of an established foreign securities exchange that is located outside the United States” or through “the facilities of a designated offshore securities market.”⁹⁹ Primary offerings of Category 1 securities are deemed to be offshore when the “offer is not made to a person in the United States” and when either the “buyer is outside of the United States” or the transaction occurs on the “physical trading floor of an established foreign securities exchange.”¹⁰⁰ Therefore, a U.S. resident who wishes to partake in a primary offering of Category 1 securities and is located in the United States can only purchase the securities on the trading floor of

⁹⁹ Commodities and Securities Exchanges, 17 C.F.R. § 230.902 (2002).

¹⁰⁰ *Id.* at § 230.903; *see id.* at § 230.902. Additionally, the definition in Rule 902(h) provides that, where the transaction does not occur on an established foreign securities exchange, a buyer need not be truly outside of the United States, but the seller need only reasonably believe that the buyer is outside of the United States.

a foreign securities exchange.¹⁰¹ This is illustrated in the left column of Figure 1.¹⁰² To the extent that issuers infrequently make offerings directly on to an exchange, however, this route often may be closed to U.S. buyers.¹⁰³

The regulatory mechanism for resales of Category 1 securities works similarly to that for primary offerings. There is only one slight difference; Rule 902(h) provides that, for resales, transactions may be executed through the facilities of a designated offshore securities market instead of the stricter requirement that trading occur on the floor of an established foreign securities exchange.¹⁰⁴ Therefore, a U.S. resident wishing to purchase Category 1 securities outside the United States must do so through a designated offshore securities market as illustrated in the right column of Figure 1.¹⁰⁵

It should be noted that, like all other securities, resales of Category 1 securities may be made into the United States when any other exemption applies. The simplest case would involve individual foreign investors using the Section 4(1) exemption, where the transaction does not involve any issuer, underwriter, or dealer. There would be no U.S. market, however, in which to make such a transaction, particularly when brokers fall under the Securities Act's definition of dealer in Section 2(a)(12). Other exemptions entail the same complications that Regulation S was intended to avoid, and most sellers would likely opt for the safe harbor of selling offshore. Therefore, a U.S. resident wishing to purchase Category 1 securities through a

¹⁰¹ The requirement that the transaction be executed on a physical trading floor has never been explained by the Commission. Daniel A. Braverman, *U.S. Legal Considerations Affecting Global Offerings of Shares in Foreign Companies*, 17 NW. J. INT'L L. & BUS. 30, n.177 (1996). Furthermore, it appears to have been relaxed in practice. For example, EASDAQ is an electronic exchange that does not have a physical trading floor but is allowed to participate in Rule 903 offerings pursuant to a Commission no-action letter. The European Association of Securities Dealers Automated Quotation N.V./S.A., ("EASDAQ"), SEC No-Action Letter, SEC No-Act. LEXIS 652 (July 27, 1999). Therefore, unless otherwise necessary, future references to this requirement will be shortened to the use of the term "established foreign securities exchange."

¹⁰² Part IV(D) of the article provides a description of how one foreign exchange handles these primary offerings in light of the restrictions of Regulation S.

¹⁰³ See Scott, *supra* note 8, at 71, 93; *Offshore Offers and Sales*, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990). An alternate route, through the use of nominee entities, may exist for U.S. residents wishing to purchase foreign primary offerings, and that route is discussed in subsection E(3) of this Part of the Article.

¹⁰⁴ *Commodities and Securities Exchanges*, 17 C.F.R. § 230.902 (2002); See *supra* note 101 (proposing, as discussed in note 101, the requirement that primary offerings to U.S. residents occur on a physical trading floor may have been relaxed).

¹⁰⁵ Apparently, some U.S. brokers make markets in foreign securities through transactions similar to pink sheet transactions, so the need for designated offshore securities markets may be undercut in some circumstances. This issue is presented briefly in Parts IV(B) and (C) the article. Part IV(D) contains a description of how one foreign exchange handles these resale transactions.

resale will usually do so through the transaction diagramed in the right column of Figure 1.

Since Rule 902(h) of the Securities Act prohibits the sale of securities directly into the United States, the only routes contemplated by Regulation S as being available to U.S. residents for purchasing Category 1 securities are those illustrated in Figure 1.¹⁰⁶ So long as U.S. residents follow these two routes, there are no other restrictions within the text of Regulation S against the sale of Category 1 securities to U.S. residents.

B. Sections 4(3) and 4(4)¹⁰⁷

Section 4(3) of the Securities Act provides another possible restriction

¹⁰⁶ The possibility of U.S. investors trading through nominee entities is discussed in subsection E(3) of this section. Additionally, the possibility of utilizing U.S. market makers in "pink sheet" transactions is touched upon in sections IV(B) and (C) of the article.

¹⁰⁷ Section 4(3) analysis in this article reflects an important difference between Regulation S and other transactional exemptions promulgated by the Commission. Most, if not all, other transactional exemptions are grounded in §§ 3 and 4 of the Securities Act. See LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATIONS x-xii (3d ed. 1999) (providing a list of transactional exemptions). These sections are not subject to the limitations of § 4(3). Regulation S, however, is based on a territorial approach to securities regulation and is grounded primarily in § 19 of the Securities Act. See *Offshore Offers and Sales*, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990). While the enacting release lists §§ 2, 3, 4, and 19 as the statutory basis of Regulation S, neither the preliminary notes, nor the body of the release actually specify the statutory grounding of Regulation S. See *id.* Section 19's reach is broad and allows the Commission to issue regulations as "necessary to carry out the provisions of" the Securities Act, but it does not explicitly exempt Regulation S from the reach of § 4(3). See 15 USCS § 77s (2001).

The other transactional registration safe-harbors are grounded in §§ 3 and 4 and are thereby outside the reach of § 4(3). Section 3(a) states that "the provisions of this title shall not apply to any of the following classes of securities." 15 USCS § 77c (2001). This explicitly negates any prohibition that § 4(3) may impose on safe-harbor exemptions based on § 3. An example would be Rule 147, which is the intrastate offering exemption. See *Commodities and Securities Exchanges*, 17 C.F.R. § 230.147 (2002). Rule 147 provides "objective standards" that allow issuers to know exactly when they qualify for the § 3(a)(11) exemption. *Id.* Issuers who meet the requirements of Rule 147 are then considered to be making an exempt offering under the § 3(a)(11) exemption. Given the general language of § 3(a), the transaction will not be subject to any of § 4's requirements.

Furthermore, § 3(b) gives the Commission the power to "add any class of securities to the securities exempted as provided in this section." 15 USCS § 77c (2001). This effectively links § 3(b) exemptions to § 3(a) and removes them from the reach of § 4(3). For this reason, safe-harbors such as Regulation A and Rule 701 are not subject to the constraints of § 4(3). See *Commodities and Securities Exchanges*, 17 C.F.R. § 203.251 (2002). Rule 251 and JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 421 (2d ed. 1997). Though the language of Regulation A is very similar to that of Regulation S, those who seek the shelter of Regulation A effectively seek the shelter of § 3(b). Once they meet the requirements of Regulation A and have the protection of § 3(b), they are protected from all other sections of the Securities Act, including both §§ 4 and 5. Rule 701 operates similarly. See, e.g.,

on U.S. residents partaking in the public offerings of Category 1 issuers.¹⁰⁸ Edward F. Greene, in his treatise on international securities and derivatives markets, writes that Section 4(3) of the Securities Act applies to Regulation S offerings so that, "even in the case of a Category 1 offering, . . . dealers are subject to the limitations of" Section 4(3).¹⁰⁹ The analysis in this article, however, indicates that Section 4(3) most likely does not pose a barrier to Category 1 offerings. Furthermore, Section 4(4) of the Securities Act appears to provide an alternate exemption that would allow U.S. residents to purchase Category 1 securities with only the restrictions imposed by Regulation S.

Section 4(3) applies the prohibitions and requirements of Section 5 of the Securities Act to transactions involving dealers within forty days of the offering.¹¹⁰ The term dealer is defined broadly by the Securities Act and includes entities that are commonly known as brokers and whose business involves trading in the securities of others.¹¹¹ Referring to Figure 1, one can see that any transaction within the confines of Regulation S requires the use of brokers that fall under the definition of dealer in the Securities Act. Thus, Mr. Greene has interpreted this combination of provisions to prohibit a dealer from selling Category 1 securities to U.S. residents within forty days of the offering.¹¹²

The following analysis shows that such is not the case. There are two sets of brokers in Figure 1: one set of brokers on the seller's side of the

JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 421 (2d ed. 1997).

Section 4 exemptions, of course, are parallel to § 4(3). As long as a transaction falls into one of those exemptions, it is exempt without having to meet the requirements of other subsections of § 4. An example would be the private offering safe-harbor provisions found in Regulation D. When issuers meet the requirements of Rule 506, they are deemed to be making a private offering "within the meaning of § 4(2) of the [Securities] Act." Therefore, the transaction would not be subject to § 4(3). See *Commodities and Securities Exchanges*, 17 C.F.R. § 230.506 (2002).

Regulation S does not appear to have a similar statutory grounding, so § 4(3) poses a concern. Furthermore, one must remember that these are all transactional exemptions, so purchasers in these exempt transactions must find their own exemption upon resale.

¹⁰⁸ Indeed, in the adopting release of Regulation S, the Commission made clear that Regulation S "does not affect the availability of the exemptions contained in" §§ 4(1) and 4(3) of the Securities Act. *Offshore Offers and Sales*, Exchange Act Release Nos. 33-6863, 34-27942 at n.137 (Apr. 24, 1990).

¹⁰⁹ Greene et al., *supra* note 50, at §§ 5.02-03, 5-27.

¹¹⁰ Section 4(3) of the Securities Act. Incidentally, § 4(3) imposes a ninety-day waiting period for securities of first-time issuers who have filed a registration statement and whose securities thereby fall under § 4(3)(B) of the Securities Act. For purposes of Regulation S, however, no issuer will have filed a registration statement.

¹¹¹ 15 USCS § 78(i) (2001).

¹¹² See Greene et al., *supra* note 50, at §§ 5.02-03, 5-27; See also Scott, *supra* note 8, at 71, 92-93; Daniel A. Braverman, *U.S. Legal Considerations Affecting Global Offerings of Shares in Foreign Companies*, 17 *NW. J. INT'L L. & BUS.* 30, 84-85 (1996).

market and a second set on the buyer's side. The brokers on the seller's side of the transaction should be exempt from Section 4(3) of the Securities Act. Section 4(3) of the Securities Act is an exemption from Section 5 of the Securities Act. Regulation S provides that Section 5 does not apply to transactions that fall within the safe harbor. Rule 901 of Regulation S states that "For the purposes only of Section 5 of the [Securities] Act, the terms 'offer,' 'offer to sell,' 'sell,' 'sale,' and 'offer to buy' . . . shall be deemed not to include offers and sales that occur outside the United States." Therefore, if the transaction meets the requirements of Regulation S, Section 5 does not apply, so Section 4(3) is meaningless as an exemption from Section 5.¹¹³

One would expect the Regulation S safe harbor to cover the entire transaction, but the possibility of separating the two sets of brokers exists.¹¹⁴ Indeed, if the buyer's brokers, whether foreign or U.S., first purchase the Category 1 securities and then sell them to the buyer, Preliminary Note 6 to Regulation S may be implicated. Preliminary Note 6 states that any securities "acquired overseas . . . may be resold in the United States only if they are registered under the [Securities] Act or an exemption from registration is available." Furthermore, even if the buyer's brokers do not actually purchase the securities but merely facilitate the transaction, the buyer's brokers may still be knowingly sending the securities into the United States. Buyer's brokers then require an exemption if the Regulation S safe harbor does not reach them.

Section 4(4) of the Securities Act may be available to buyer's brokers. Section 4(4) grants an exemption from Section 5 of the Securities Act for transactions that are executed by a broker "upon customers' orders" where such orders were not solicited by the broker.¹¹⁵ Since the definition of dealer is broad enough to include all brokers, the "Section 4(4) exemption depends not upon a firm's generally acting as a broker but upon the capacity in which it executes the particular transaction."¹¹⁶ Furthermore, the Section 4(4) exemption is only necessary when the Section 4(3) dealers' exemption is not available, such as when the transaction occurs within forty days of the issuance of the security.¹¹⁷ If the Section 4(4) exemption is available to brokers executing buy orders on foreign markets, there would be no prohibitions against U.S. residents purchasing Category 1 securities upon their issuance through an established foreign securities exchange or on a designated offshore securities market.

¹¹³ See Jackson & Pan, *supra* note 1, at 654.

¹¹⁴ See *id.*

¹¹⁵ 15 USCS § 77d (2001).

¹¹⁶ LOSS & SELIGMAN, *supra* note 107, at § 3-C-8.

¹¹⁷ *Id.*

The Section 4(4) exemption should be available to brokers executing buy orders on behalf of U.S. clients. The history of Section 4(4) implies that the exemption is intended to benefit buyers. The House committee explained that Section 4(4) allowed innocent purchasers of the securities of an issuer to sell those securities even when a stop order has been imposed against further distribution of those securities.¹¹⁸ Indeed, “[i]n adopting Rule 144, the Commission made clear, ‘The broker may not solicit buy orders. . . .’ This seems to be . . . consistent with the statutory emphasis on protection of the purchaser.”¹¹⁹ So long as U.S. purchasers contact brokers, there should be no Securities Act violations.

The mechanics of Rule 144 and Section 4(4) also support such an interpretation of the exemption. Rule 144(g) defines the term “brokers’ transactions” as used in Section 4(4) for purposes of Rule 144.¹²⁰ Under the Rule 144 interpretation of Section 4(4), brokers are permitted to work for buyers and to receive their commission from buyers, “as long as the commission is limited to the ‘usual and customary brokers’ commission.”¹²¹ Rule 144(g)(ii) states that brokers are allowed to contact their customers who have indicated interest in a security in the past ten business days.¹²² Furthermore, the Commission “permit[s] a broker to solicit affiliates of an issuer to sell their securities.”¹²³

If the Rule 144 interpretation of section 4(4) applies to the Regulation S context, U.S. purchasers will have no legal barriers to acquiring Category 1 securities. United States purchasers would simply contact brokers and place buy orders. In the event that the securities are not available, brokers can contact the interested buyers when the securities become available on an established foreign securities exchange or designated offshore securities market if that happens within ten days. Brokers, however, may not actually be able to solicit affiliates of the issuer in the Regulation S context because Rules 904 and 902 state that sellers must reasonably believe that buyers are outside the United States. If U.S. brokers contacted distributors, these distributors would know that any sales would be made for the benefit of a

¹¹⁸ *Id.*

¹¹⁹ *Id.* (footnotes omitted).

¹²⁰ Rule 144(g) defines brokers’ transactions “[f]or the purposes of both Rule 144(f) and § 4(4).” Loss & Seligman, *supra* note 107, at § 3-D-2 (emphasis added). The actual statute, however, indicates that the definition in Rule 144 is only intended “for the purposes of this rule.” Commodities and Securities Exchanges, 17 C.F.R. § 230.144 (2002). Rule 144(g) is, “implicitly, . . . the current Commission interpretation of § 4(4)” because Rule 144 replaced Rule 154, which had defined § 4(4). Loss & Seligman, *supra* note 107, at § 3-C-8 1565, 1567.

¹²¹ Loss & Seligman, *supra* note 107, at § 3-D-2 (footnote omitted).

¹²² *Id.*; See also Commodities and Securities Exchanges, 17 C.F.R. § 230.144 (2002).

¹²³ Loss & Seligman *supra* note 107, at § 3-D-2.

U.S. resident. Therefore, not every aspect of the Rule 144 interpretation of a broker's transaction can be made applicable to Regulation S.

Though the full Rule 144 interpretation of Section 4(4) may not be applicable to the Regulation S context, those areas that do not conflict directly with Regulation S should apply. Application of the Rule 144 interpretation of Section 4(4) to Regulation S would be consistent with the purchaser protection objectives of the exemption; in the Regulation S context, the broker acts on behalf of the buyer. Furthermore, Regulation S expressly states that Rule 144's definition of restricted securities applies to domestic equity securities issued pursuant to Regulation S.¹²⁴ The Commission's intent is to use Rule 144 as a structured method by which purchasers of domestic equity securities may sell those securities back into the United States.¹²⁵ Even though Rule 144(g) is a part of an integrated and intricate set of rules, to use disparate definitions of the Section 4(4) exemption for Rule 144 and Regulation S would seem anomalous and unwarranted given the express and intricately balanced linkages between these rules. Therefore, the Rule 144 interpretation of Section 4(4) should be applied to Regulation S transactions to the fullest extent possible.

Allowing U.S. purchasers to contact brokers for purchasing Category 1 securities on an established foreign securities exchange or designated offshore securities market is consistent with both the history and the Commission's reading of Section 4(4). Therefore, brokers who do not actively market Category 1 securities to their customers but who are requested by their customers to purchase such securities on a foreign market should be free of any restrictions of the Securities Act.¹²⁶

C. Rule 15a-6

While the Securities Act appears to allow U.S. investors to purchase securities abroad with few restrictions, the Exchange Act presents another, less direct, method of regulating such transactions. As discussed above, Regulation S forces most U.S. residents wishing to purchase Category 1 securities to do so through an established foreign securities exchange or designated offshore securities market. This requires U.S. residents to purchase such securities through brokers as depicted in Figure 1. The Exchange Act requires broker-dealers to register with the Commission. This, then, presents an alternate, though less direct, route through which the

¹²⁴ Commodities and Securities Exchanges, 17 C.F.R. § 230.905 (2002).

¹²⁵ Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998).

¹²⁶ Part IV this article presents anecdotal evidence that § 4(3) is not a concern to professionals in the financial industry.

Commission can regulate transactions of U.S. investors in foreign securities.¹²⁷

Rule 15a-6 provides an exemption from the registration requirements of the Exchange Act for foreign broker-dealers. Foreign brokers that meet the requirements of this rule are allowed to do business with U.S. investors without registration. Should U.S. investors buy foreign securities through such foreign brokers, the transaction would again be completely unregulated by the Commission.

A brief description of Rule 15a-6 is in order. The enacting release for Rule 15a-6 discussed the exemption in terms of two different types of contacts between foreign broker-dealers and U.S. persons: non-direct and direct. Non-direct contacts include unsolicited transactions for U.S. investors, discussed below, and the provision of research to major U.S. institutional investors.¹²⁸ The Commission does not consider the provision of research reports as direct contact because broker-dealers providing such reports are not permitted to initiate contact with investors to follow up on the reports and because the report itself must not recommend the use of the broker-dealer.¹²⁹ "Major" U.S. institutional investors are defined to be U.S. institutional investors with assets, or assets under management, of more than \$100 million.¹³⁰ This exemption was created because of a desire on the part of U.S. institutional investors to access foreign research and because of the Commission's belief that this position is "consistent with the free flow of information across national boundaries . . . [and that the exemption does not] rais[e] substantial investor protection concerns."¹³¹

Under the enacting release to Rule 15a-6, direct contacts between foreign broker-dealers and U.S. investors fall into two categories. First, solicitation of U.S. institutional investors constitutes direct contact and is permitted so long as transactions with or for these investors are executed through a registered intermediary. Second, transactions with "registered broker-dealers, banks acting [as broker-dealers], certain international organizations, foreign persons temporarily present in the United States, [U.S.] citizens resident abroad, and foreign branches and agencies of [U.S.]

¹²⁷ Part IV(C) discusses how two U.S. broker-dealers accommodate U.S. residents who wish to purchase securities abroad.

¹²⁸ Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 34-27017 (July 11, 1989).

¹²⁹ Commodities and Securities Exchanges, 17 C.F.R. § 240.15a-6 (2002). Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 34-27017 (July 11, 1989).

¹³⁰ Commodities and Securities Exchanges, 17 C.F.R. § 240.15a-6 (2002).

¹³¹ Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 34-27017 (July 11, 1989).

persons" are permitted.¹³² The use of a registered intermediary is intended by the Commission as a method of maintaining some regulatory safeguards; the registered intermediary bears responsibility for a number of the transactional requirements of registered broker-dealers even though the intermediary itself is merely a conduit.¹³³ The second set of direct contact exemptions incorporate prior no-action letters and make the rule consistent with other rules and regulations.¹³⁴

For purposes of Regulation S, the primary concern is with the exemption for unsolicited transactions embodied in Rule 15a-6(a)(1). Under Rule 15a-6(a)(1), so long as the U.S. investor initiates the transaction, the broker-dealer does not have to register.¹³⁵ This is because the Commission believes that, in such situations, U.S. investors would not expect the foreign broker-dealers to be subject to U.S. broker-dealer requirements.¹³⁶ Furthermore, the Commission also believes that, in such situations, requiring registration would cause foreign broker-dealers to refuse to deal with U.S. persons under any circumstances.¹³⁷ Such a result seemingly would hurt U.S. investors by preventing those who knowledgeable want to invest abroad from doing so.

So long as foreign broker-dealers do not solicit U.S. investors, U.S. investors may invest in securities abroad through unregistered broker-dealers and thereby bypass all forms of U.S. regulation.

D. *Contacts and Solicitation*

The main thrust of the Commission's restrictions on investment in unregistered foreign securities appears to be aimed at preventing advertising and solicitation from reaching U.S. residents. As has been demonstrated above, U.S. residents are free to contact brokers, U.S. or foreign, and invest in foreign securities through established foreign securities exchanges and designated offshore securities markets. They can only do this, however, if they know about an offshore offering. Accordingly, each of the three regulations described above has incorporated provisions that restrict contact between foreign sellers or brokers and U.S. investors. Under Regulation S, issuers and underwriters are not allowed to make directed marketing efforts

¹³² *Id.*

¹³³ *See id.*

¹³⁴ *See id.*

¹³⁵ A more detailed description of what constitutes solicitation under Rule 15a-6(a)(1) is below.

¹³⁶ Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 34-27017 (July 11, 1989).

¹³⁷ *Id.*

into the United States, nor are they allowed to make offers into the United States. In Section 4(4), the brokers' transaction must be unsolicited. Similarly, under Rule 15a-6(a)(1), brokers do not have to register if the transaction is unsolicited. This section seeks to compare the three different provisions and determine the limits of interaction between foreign sellers and brokers and U.S. investors.

One begins with Regulation S. The limits of Regulation S apply to issuers and underwriters of securities and prohibit any offers to U.S. persons.¹³⁸ Presumably, since the Commission has not specifically defined the term "offer" for purposes of Regulation S, that term would have a similar definition in this context as it would have for purposes of Section 5 of the Securities Act. Support for this presumption may be found in the Commission's release on internet offers, where they assume that information posted on a web site would "constitute an 'offer' within the meaning of Section 5(c) of the Securities Act and Regulation S."¹³⁹ At least for Internet purposes, then, Regulation S offers appear to be the same as Section 5 offers.

While the Commission has not defined offers for Regulation S offerings in general, the Commission has promulgated specific suggestions concerning offshore offers made over the Internet. The Commission recommends that issuers and distributors include prominent disclaimers stating that an Internet offer is not intended for U.S. persons. Furthermore, web sites should include procedures, such as getting a potential purchaser's address, that guard against sales to U.S. persons.¹⁴⁰

Some of the ambiguity concerning what constitutes an offer for non-Internet related distributions might be clarified by the second restriction of Regulation S. This restriction is against directed selling efforts into the United States. Those acts specifically made available to foreign issuers under that restriction, presumably, would not constitute an offer to a U.S. person. The acts made available to foreign issuers and distributors follow:

- 1) advertisements required by U.S. or foreign law provided that the advertisement includes no more information than that required by law;
- 2) tombstone advertisements in publications with less than 20% of their circulation in the United States;

¹³⁸ Much of the statutory detail was provided in Part II(B)(1).

¹³⁹ Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore, Exchange Act Release Nos. 33-7516, 34-39779 (Mar. 23, 1998). Internet offers were also discussed in Part II(B)(1).

¹⁴⁰ *Id.*

- 3) visits of investors to facilities in the United States;
- 4) distribution of a foreign broker-dealer's quotations as part of a third-party system that distributes such quotations primarily in foreign countries;
- 5) notices in accordance with Rules 135 and 135c; and
- 6) access for U.S. journalists to press conferences held outside the United States.¹⁴¹

These acts are explicitly permitted by the Commission as acts that do not constitute directed marketing efforts. They also, presumably, would not constitute offers to U.S. persons since the Commission has explicitly condoned them. Similarly, offer rules also help define what constitutes a directed marketing effort. The internet restrictions that prevent a web site from becoming an offer into the United States may also prevent the web site from being deemed a directed marketing effort into the United States. This is because, in the context of web sites, the Commission focuses on determining when "offshore [i]nternet offers to which [U.S.] persons can gain access [are deemed] not to occur in the United States."¹⁴² Web sites that do not occur in the United States are, by definition, not in the United States and seemingly would not be considered directed marketing efforts into the United States. The Commission's release is, however, limited to offers specifically.

The restrictions on offers and directed marketing efforts are not entirely coextensive. Acts that would not constitute directed marketing efforts might be considered offers. Specifically, acts that aim at particular individuals or groups may be considered "offers for purposes of Regulation S or solicitation for purposes of Rule 15a-6, [but] they generally will not constitute directed selling efforts for purposes of . . . Regulation [S] because of their confined effect."¹⁴³ Isolating marketing efforts that will not be considered offers, however, is difficult if not impossible. The term "offer" is broadly defined in Section 2(a)(3) of the Securities Act to "include every attempt . . . to dispose of . . . a security . . . for value." Thus, potentially all marketing efforts can also be viewed as offers, and the internet restrictions discussed in the prior paragraph would apply widely.

¹⁴¹ Commodities and Securities Exchanges, 17 C.F.R. § 230.902 (2002).

¹⁴² *Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore*, Exchange Act Release Nos. 33-7516, 34-39779 (Mar. 23, 1998).

¹⁴³ *Offshore Offers and Sales*, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

The prohibition on solicitation in Section 4(4), which is necessary for a U.S. person to buy foreign securities, is unfortunately also not clear.¹⁴⁴ Registered brokers are allowed to advertise themselves as brokers, and that distinction will become critical below.¹⁴⁵ Aside from that obvious ability, the prohibition against solicitation is embodied in Rule 144(g), as discussed above. Briefly, a registered broker falling under the Section 4(4) exemption may do the following:

- 1) execute a sell order for no more than the usual and customary broker's commission;
- 2) make inquiries of other brokers who have indicated an interest in the securities within the preceding 60 days;
- 3) make inquiries of customers who have indicated an unsolicited bona fide interest in the securities within the preceding 10 business days; and
- 4) publish bid and ask quotations in an inter-dealer quotation system subject to certain limitations.¹⁴⁶

Though the Commission's guidance in this area is scant, it appears sufficient for the purposes of this article. The registered brokers that concern this article are those who act as agents on behalf of U.S. persons wishing to invest in foreign securities. Such brokers, though they may be thought of as seeking buy orders from U.S. persons, do not have an interest in purchasing a particular security for their clients. Any security will be just as good so long as the brokers receive their commissions. Therefore, the concern is with situations where brokers advertise the fact that they are available to aid in transactions of a whole list of securities that include foreign Category 1 securities. Such brokers, so long as they are unaffiliated with any issuer or distributor, may distribute, as part of their general advertising, information concerning foreign securities.¹⁴⁷ Prohibition of

¹⁴⁴ In reference to solicitation, Loss and Seligman write, "Section 4(4) is not a model of clarity." Loss and Seligman, *supra* note 107, at § 3-C-8.

¹⁴⁵ *Id.*

¹⁴⁶ Rule 144(g). The bid and ask quotations permitted to be published are for "the maintenance of a bona fide inter-dealer market for the security [in question] for the broker's own account." Rule 144(g)(2)(iii). Presumably, brokers that are not market-makers may not publish bid and ask quotations. This restriction seems redundant in light of the frequency requirements placed on the publication of quotations by Rule 144(g)(2)(iii).

¹⁴⁷ Registered brokers, of course, must still behave in accordance with the rules and regulations of their respective exchanges. While a detailed treatment of such rules is beyond the scope of this article, it should be noted that the suitability rules in particular may be implicated by the transactions discussed. Of specific interest to this article, "although the [Commission] has stated that suitability applies to the

directed marketing efforts is limited to issuers, distributors, and their affiliates.¹⁴⁸

While Rule 144(g) lays out the issue of broker solicitation for registered brokers, Rule 902(c)(3)(v) and Rule 15a-6 address the issue with respect to foreign brokers. Specifically, Rule 902(c)(3)(v) provides for restrictions on the publication of broker-dealer quotations that are different from those listed in Rule 144(g)(2)(iii). Since, the term foreign broker is not defined in Regulation S or in its enacting release, registered foreign brokers could potentially be included in the restrictions of Rule 902(c)(3)(v). If that is the case, then a registered foreign broker who follows Rule 144(g)(2)(iii) could still be found in violation of Regulation S for failure to follow Rule 902(c)(3)(v). This is because Rule 902 would presumably take precedence over Rule 144 in a Regulation S dispute.

Rule 902(c)(3)(v) provides that only the bid and ask quotations of a foreign broker-dealer may be distributed in the United States. Furthermore, these quotations may be distributed only pursuant to a third-party system that distributes such quotations primarily in foreign countries.¹⁴⁹ An additional safeguard in Rule 902(c)(3)(v) is the prohibition against executions, via this quotation system, of transactions between U.S. persons and the foreign broker-dealer. Finally, the rule restricts contacts between such foreign broker-dealers and U.S. persons to those allowed by Rule 15a-6. This effectively makes the relevant solicitation standard for foreign brokers, registered or unregistered, that of Rule 15a-6.¹⁵⁰

Rule 15a-6(a)(1) has its own definition of solicitation. The essential difference between the definition here and that governing Section 4(4) is the advertising of brokers' services. Foreign brokers who are not registered cannot advertise their services to U.S. investors. The Commission writes that solicitation, for Rule 15a-6 purposes, would include "any affirmative effort by a broker or dealer intended to induce transactional business for the

online context[.] . . . [i]t has at this point largely accepted the industry position that online trading operates as a discount brokerage and thus does not trigger application of the [National Association of Securities Dealers] suitability rules." Shirley Lo, *Suitability and Online Trading* 22 (Feb. 16, 2001) (unpublished, on file with author). Presumably, the trading of foreign stocks on-line would be no different, and unaffiliated registered brokers can, at present, trade in foreign securities for retail customers without suitability implications.

¹⁴⁸ Commodity and Securities Exchanges, 17 C.F.R. § 230.903 (2002); Commodity and Securities Exchanges, 17 C.F.R. § 230.904 (2002).

¹⁴⁹ Commodity and Securities Exchanges, 17 C.F.R. § 230.902(c)(3)(v) (2002).

¹⁵⁰ Rule 15a-6 is generally applicable only to unregistered foreign brokers. As noted above, however, Regulation S has made the rule explicitly applicable to all foreign brokers. Without other language in either the statute or Commission releases, it appears that Rule 15a-6 would also become applicable to registered foreign brokers.

broker-dealer or its affiliates.”¹⁵¹ It continues by stating that “efforts ... to develop an ongoing securities business relationship” would constitute solicitation.¹⁵²

While the theory of non-solicitation seems clear, the application of Rule 15a-6 is not. Similar to the solicitation rules of Section 4(4), the Commission has provided little guidance on what activities would be prohibited. While the enacting release of Rule 15a-6 listed a number of activities that would constitute solicitation, the Commission asserted that it would “determine the term’s meaning on a case-by-case basis, taking into account [Commission] precedents.”¹⁵³ The Commission did indicate, however, that a system for distributing bid and ask quotations in a manner similar to that described in Rule 902(c)(3)(v) may be allowed.¹⁵⁴ Again, the Commission reserved the right to determine the validity of each such distribution system on a case-by-case basis or through future rulemaking.¹⁵⁵ Additionally, as noted above, acts that are not deemed to be directed market efforts under Regulation S could be considered solicitation for purposes of Rule 15a-6.¹⁵⁶

The Table below summarizes this evaluation.

As can be seen in the Table, the Commission has addressed web sites that sell securities but has not provided guidelines for Internet marketing or Internet publication of information by unrelated third parties. There are presently a number of web sites that provide information on unregistered offerings.¹⁵⁷ Presumably, as global use of the Internet expands over the next few years, such sites will become an increasingly significant issue. Specifically, unrelated third party web publication of information concerning unregistered offerings may become particularly problematic. As discussed above, most marketing campaigns run by issuers and distributors will also be considered offers under the Securities Act’s broad definition of offer in Section 2(a)(3). Information provided by unrelated third parties, though, will probably not be considered an offer by the issuer or its affiliates.¹⁵⁸

¹⁵¹ Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 34-27017 (July 11, 1989).

¹⁵² *Id.*

¹⁵³ Greene, et al., *supra* note 50, at § 9.03, 9-16 to 9-17.

¹⁵⁴ Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 34-27017 (July 11, 1989).

¹⁵⁵ *Id.*

¹⁵⁶ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

¹⁵⁷ A search on <http://www.google.com> brought up several web sites that listed information on recent and upcoming initial public offerings (“IPOs”) in Europe. For more information on these sites, see the Appendix.

¹⁵⁸ *But see* Pinter v. Dahl, 486 U.S. 622 (1988), *reprinted in abridged form in* Cox et al., *supra* note 107, at 621.

<u>Authority</u>	<u>Language</u>	<u>Allowed Activities</u>
Regulation S	No offers into the United States	Probably same as those for domestic offers pursuant to section 5 of the Securities Act. Web sites that sell securities so long as there are disclaimers against sales into the United States and safeguards, such as getting visitor's mailing address.
	No directed marketing efforts	Advertisements required by U.S. or foreign law provided that the advertisement includes no more information than that required by law. Tombstone advertisements in publications with less than 20% of their circulation in the United States. Visits of investors to facilities in the United States. Distribution of a foreign broker-dealer's quotations as part of a third-party system that distributes such quotations primarily in foreign countries. No method of trading between U.S. person and foreign broker-dealer. See Rule 15a-6 for limitations on contacts between foreign broker-dealers and U.S. persons. Notices in accordance with Rules 135 and 135c. Providing U.S. journalists with access to press conferences held outside the United States. Web sites that sell securities so long as there are disclaimers against selling into the United States and safeguards, such as getting visitor's mailing address.
Section 4(4)	No solicitation of orders by brokers	Advertise self as broker. Execute a sell order for no more than the usual and customary broker's commission. Make inquiries of other brokers who have indicated an interest in the securities within the preceding sixty days. Make inquiries of customers who have indicated an unsolicited bona fide interest in the securities within the preceding ten business days. Publish bid and ask quotations.
Rule 15a-6(a)(1)	No solicitation of persons by foreign broker-dealer	No advertising of brokers' services. Possibly a quotations distribution system similar to that allowed by Regulation S.

Thus, U.S. residents may become alerted to information about unregistered offerings as they surf the web.

E. *Goals and Theories of Regulation S*

The interpretation of Regulation S and other rules discussed above is in accord with the underlying goals of Regulation S. The regulation, as interpreted above, prohibits U.S. residents from purchasing unregistered foreign securities when there may be sufficient solicitation to entice them to purchase such securities without full knowledge concerning the foreign issuers. The interpretation, however, also allows U.S. residents to purchase such foreign securities freely when it is likely that the investors have the knowledge and skills to fully understand their investment. Unfortunately, there appear to be two possible exceptions where the policies behind Regulations S may be circumvented. The first possible exception arises when U.S. companies or investors situated in a foreign country invest pursuant to Regulation S; the second exception arises when U.S. investors and companies invest through nominee entities.

1. CONSISTENCY WITH THE GOALS OF REGULATION S

Regulation S depends on the categorization of securities in order to provide what the Commission deems as the appropriate amount of protection for U.S. capital markets and investors. In enacting Regulation S, the Commission stated that "registration of securities is intended to protect the [U.S.] capital markets and investors purchasing in the [U.S.] market, whether [U.S.] or foreign nationals."¹⁵⁹ With this purpose in mind, the Commission divided U.S. and foreign securities into three categories based on "the likelihood of flowback [of an issuer's securities] into the United States and the degree of information available to [U.S.] investors regarding such securities."¹⁶⁰ Category 1 securities have the lowest likelihood of flowback while Category 2 and Category 3 securities have a higher likelihood of flowback. Category 2 securities, however, have more information available to U.S. investors than do securities classified as Category 3.

In enacting Regulation S, the Commission's adopting release devotes a full paragraph to explaining how each type of security classified within

¹⁵⁹ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

¹⁶⁰ *Id.* Likelihood of flowback, of course, is directly affected by the amount of advertising and solicitation allowed in the United States.

Category 1 has a low likelihood of flowback.¹⁶¹ For instance, securities of issuers with no substantial U.S. market interest in their securities “are not likely to flow into the United States.”¹⁶² Substantial U.S. market interest is defined, for purposes of equity securities, by the proportion of an issuer’s total equity securities traded on exchanges or systems inside the United States.¹⁶³ Thus, if certain securities do not trade in the United States, the numbers of U.S. residents wishing to purchase them are expected to be extremely low. Indeed, in enacting rules to facilitate U.S. press access to foreign press activities, the Commission exempted from the “Written Materials Requirements” offerings by foreign private issuers and foreign governments that were wholly offshore “because those offerings would appear to be of less significant interest to [U.S.] investors.”¹⁶⁴ In short, press requirements could be relaxed for offerings where the likelihood of flowback was low.¹⁶⁵ Moreover, when trading occurs abroad, U.S. markets would not be directly hurt by fraud or insufficient disclosure; only U.S. investors trading abroad would be directly injured.¹⁶⁶

Where Category 2 securities are concerned, the adopting release of Regulation S emphasizes the information available to U.S. investors via the Exchange Act and the institutional structure of the markets of some of these securities. Thus, Category 2 classification was allowed for non-reporting foreign debt issuers because “the generally institutional nature of the debt market and the trading characteristics of debt securities” were deemed

¹⁶¹ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

¹⁶² *Id.* This concept is consistent with the Commission’s policy prior to the enactment of Regulation S. In its proposing release, the Commission explained its position of allowing investors who have purchased securities in a private offering as part of a French privatization “to resell the securities on the Paris Bourse without investigation as to the nationality or residence of the counter-party.” This was because of “limited [U.S.] investor participation on the Bourse and the absence of an active market for the securities in the United States.” Offshore Offers and Sales, Exchange Act Release No. 33-6779 (June 17, 1988).

¹⁶³ Commodity and Securities Exchanges, 17 C.F.R. § 230.902(j)(1) (2002). Substantial U.S. market interest in debt securities is defined by the number of U.S. holders. Commodity and Securities Exchanges, 17 C.F.R. § 230.902(j)(2) (2002).

¹⁶⁴ Offshore Press Conferences, Meetings with Company Representatives Conducted Offshore and Press-Related Materials Released Offshore, Exchange Act Release Nos. 33-7470, 34-39227 (Oct. 17, 1997).

¹⁶⁵ There is no indication that these securities constitute a particular sub-class within Category 1. While they do represent securities with which the Commission appears to be particularly comfortable, there is no indication of the use of this sub-class outside of the “Written Materials Requirements” exemption.

¹⁶⁶ Injury to substantial numbers of U.S. investors, however, could affect U.S. markets as such investors are likely to hold U.S. securities as well. Once they have lost money abroad, these U.S. investors may need to liquidate positions in U.S. markets for cash, or they may do so merely out of fear.

adequate protection for U.S. investors and markets.¹⁶⁷ Furthermore, reporting foreign issuers with substantial U.S. market interest are classified as Category 2 issuers on the theory that, if flowback occurs after the distribution compliance period, "the information relating to such securities publicly available under the Exchange Act generally should be sufficient to ensure investor protection."¹⁶⁸

With these classifications, the above interpretation of Regulation S is completely in accord with the underlying policies of Regulation S. Foreign issuers that meet the substantial U.S. market interest test and that file with the Commission are classified as Category 2 issuers, and their securities are subject to a distribution compliance period. United States investors, then, cannot be harmed until sufficient information is available. For Category 1 issuers, there is little U.S. interest in their securities. So long as there is no advertisement or solicitation within the United States, few U.S. investors will even know about, much less wish to purchase, these offerings. There is no need then to impose a distribution compliance period. Indeed, any investor who spends the time and energy to find out about such offerings, despite the lack of advertisement and readily available information, is likely also to have found sufficient information as to not need the protections of the Securities Act.¹⁶⁹ Such investors should be allowed to purchase, and the securities laws allow them to do so.

The Commission's recent actions also appear to be consistent with this theoretical explanation. In 1998, when the Commission moved all U.S. equity securities to Category 3, it refrained from moving foreign equity securities as well.¹⁷⁰ As part of the move, the Commission extended the distribution compliance period for U.S. equity securities to one year and made these securities restricted securities subject to the restrictions of Rule 144.¹⁷¹ The Commission wished to prevent investors from purchasing U.S. equity securities pursuant to Regulation S "with a view to distributing those securities into the [U.S.] markets at the end of the [then forty]-day

¹⁶⁷ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

¹⁶⁸ *Id.* The same rationale was posited in the proposing release. Offshore Offers and Sales, Exchange Act Release No. 33-6779 (June 17, 1988). As noted above, reporting U.S. issuers were moved from Category 2 to Category 3 because of the high rate of flowback that resulted from abuses of Regulation S. Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998).

¹⁶⁹ Additionally, the SEC believes that investors who reach out and purchase on a foreign securities market "will rely on the protection of the local securities law." Offshore Offers and Sales, Exchange Act Release No. 33-6779 (June 17, 1988).

¹⁷⁰ See Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998). This move was also discussed in Part II(B)(2) of this article.

¹⁷¹ See *id.*

distribution compliance period.”¹⁷² By excluding foreign securities from Category 3, the Commission implies that such securities may be resold into the United States immediately at the end of the distribution compliance period. For Category 2 securities, the distribution compliance period is forty days, and there is no distribution compliance period for Category 1 securities. In its release, the Commission seemingly acknowledged the fact that Regulation S did not prohibit the sale of foreign securities into the United States under such conditions. The Commission deliberately “reminded [purchasers of foreign securities] that Regulation S does not provide a safe harbor for resales of securities into the United States, and [that] any resales must be made pursuant to a registration statement or an exemption from the Securities Act.”¹⁷³ The Commission seems to allow resales of foreign securities into the United States and appears to be aware of resales into the United States. Given the Commission’s tone and the prohibition on solicitation, such resales must be sufficiently rare as to not jeopardize substantial numbers of U.S. investors or U.S. markets.¹⁷⁴

Furthermore, in not extending the scope of Rule 905 to foreign securities, the Commission recognized “that it [is] impossible to keep track of the restricted status of securities trading in offshore securities markets.”¹⁷⁵ In this way, the Commission appears to be implicitly acquiescing to the realities of foreign markets and allowing some such securities to flow into the United States. Again, the number of such securities flowing into the United States must be sufficiently small so as not to jeopardize U.S. markets or significant numbers of U.S. investors. The Commission has stated that it “will revisit the issue if abuses occur.”¹⁷⁶

¹⁷² Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998). Under the Rule 144 restrictions, U.S. equity securities may only be sold into the U.S. following the one-year distribution compliance period in accordance with the safe harbor restrictions of Rule 144. Greene, et al., *supra* note 50, at §§ 5.02-5.03, 5-25. For non-affiliates, such restrictions do not expire until two years after the purchase of the securities from an issuer or a distributor. Rule 144(k).

¹⁷³ Offshore Offers and Sales, Exchange Act Release Nos. 33-7505, 34-39668 (Feb. 25, 1998).

¹⁷⁴ The Commission stated that it “remains concerned with the potential for abuse” in the area of foreign securities. *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.* There is a distinction between issuers deliberately using Regulation S as a vehicle for making unregistered offerings into the United States and the unintended flow of large numbers of unregistered foreign securities into the United States. Presumably, the Commission would revisit the categorization of foreign equity securities in either of these cases.

2. EXCEPTION 1: RESIDENCY STANDARD

There is an ostensible exception to how well the rules align with the theories underlying Regulation S. Certain U.S. citizens and entities are allowed to purchase securities without regard to the issues of possible flowback and available information. United States nationals living abroad may invest freely in offshore offerings.¹⁷⁷ Similarly, “an authorized employee [who] places the buy order while abroad” meets “the requirement that the buyer be outside the United States.”¹⁷⁸ Therefore, such individuals and entities that may have close ties to the United States and to U.S. markets are left unprotected by the securities laws.¹⁷⁹

Closer inspection of this situation, however, reveals that the policy concerns of flowback and available information are still met. In situations where U.S. citizens living abroad or U.S. companies operating abroad purchase foreign securities, the possibility of harm to U.S. markets and the vast majority of U.S. residents is extremely small. Securities purchased by U.S. citizens or U.S. companies abroad are unlikely to make their way to U.S. markets. There are two ways in which such securities can reach the United States: by resale, or by a physical relocation of the investor. These investors, however, cannot resell their securities into the United States without meeting the requirements of Rule 904 like any other foreign investor.¹⁸⁰ Relocation is a big task and is infrequent for individuals and certainly unlikely for companies that are organized specifically for the task of doing business in a foreign country. Just as with Category 1 issuers, the concerns of flowback are so small as to outweigh any concerns about lack of information.¹⁸¹ Additionally, while U.S. companies may send employees

¹⁷⁷ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990). This was also discussed briefly in Part II(B)(1).

¹⁷⁸ *Id.* Only “subsidiaries and affiliate[s]” of U.S. companies that “have separate legal identities” are allowed to purchase securities in Categories 2 and 3 during the distribution compliance period because such purchasers are not considered U.S. persons if they are incorporated abroad. *Id.* This distinction between the residency requirement of “offshore transactions” and the definition of “U.S. person” was discussed in section Part II(B)(1) of this article.

¹⁷⁹ Of course, this exception would exist regardless of whether or not brokers for U.S. persons purchasing offerings are eligible for the § 4(4) exemption.

¹⁸⁰ Of course, as stated above, the Commission may have difficulty keeping track of resales. United States citizens may be more likely to resell their securities into the United States by virtue of their close ties with the country. In this case, U.S. citizens who purchase abroad may pose a greater threat to the policies behind Regulation S than others who purchase abroad.

¹⁸¹ There may or may not be a lack of information. This depends on the local country’s securities laws and the investors’ familiarity with the customs of the local country. These investors, however, will

abroad to purchase securities and then transfer them back to the United States, such situations seem rare outside of the financial industry. Furthermore, financial corporations that have employees abroad who are authorized to transact on behalf of the corporation are likely to be able to protect themselves through research.

3. EXCEPTION 2: NOMINEE ENTITIES¹⁸²

The second possible exception to the smooth implementation of Regulation S's policies may be more formidable and is certainly more confusing. United States investors sometimes trade through offshore nominee companies. This is shown in Figure 2, below, as an additional route beyond those depicted in Figure 1. The nominee entity will be foreign and will not be treated as an U.S. entity. As shown, U.S. investors may trade foreign securities through accounts with these entities. Often foreign issuers and brokers will not know who owns the account but only that they are trading with a nominee company.

Regulation S, though it does not explicitly address nominee entities, seems to impose a look through requirement on sellers. Recent Commission announcements on the subject, however, seem to indicate more tolerance. Any look through requirement for Regulation S must be considered in light of these recent pronouncements, as they explicitly discuss nominee entities.

a. *Analysis of Regulation S and Nominee Entities*

Regulation S itself does not directly address nominee companies. Rule 902(k)(vi) states that "[a]ny non-discretionary account or similar account . . . held by a dealer or other fiduciary for the benefit or account of a [U.S.] person" is considered a U.S. person. The enacting release does not discuss nominee companies specifically but states that the statute "treats the person with the investment discretion as the buyer."¹⁸³ Furthermore, the enacting release states that, for purposes of an offshore transaction, "the buyer itself, rather than its agent, [must] be outside the United States."¹⁸⁴ Nominee accounts can likely be captured under these provisions. In that case, trading

be less likely to believe that U.S. securities laws can protect them, and this lack of dependence makes their exemption from Regulation S less damaging.

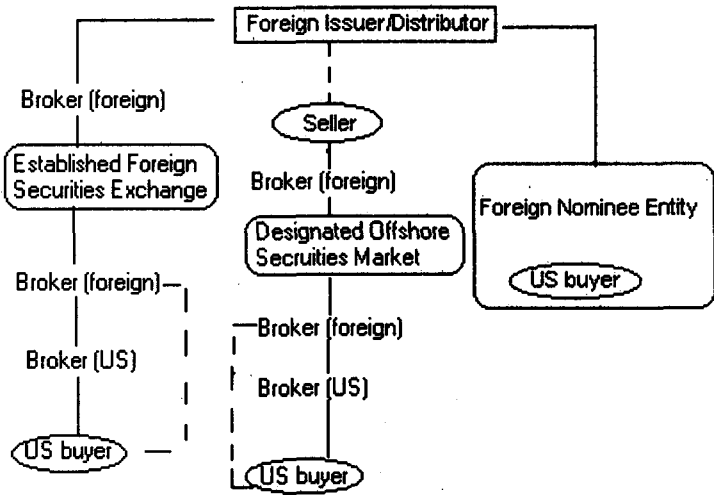
¹⁸² Part IV(E) presents an example where significant numbers of transactions were conducted through the use of nominee entities.

¹⁸³ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

¹⁸⁴ *Id.*

with U.S. residents through nominee accounts would be deemed a breach of Regulation S, so a look through requirement would be effectively incorporated.

Figure 2.



While the language of the enacting release quoted above seems to indicate that Regulation S imposes a look through requirement, the language of Rule 902 itself may be more generous. Rule 902(h) defines offshore transactions. It allows the transaction to occur so long as “the seller and any person acting on its behalf reasonably believe that the buyer is outside the United States.”¹⁸⁵ Perhaps, sellers may reasonably believe that a beneficial buyer is located where the nominee entity is located. This would eliminate the look through requirement for Category 1 securities. Category 2 and 3 securities are subject to trading restrictions during their respective distribution compliance periods.¹⁸⁶ For primary offerings, these restrictions

¹⁸⁵ Commodity and Securities Exchanges, 17 C.F.R. § 230.902(h)(ii)(A) (2002).

¹⁸⁶ Commodity and Securities Exchanges, 17 C.F.R. § 230.903 (2002); Commodity and Securities Exchanges, 17 C.F.R. § 230.904 (2002).

specifically state that sales are not to be made to U.S. persons, and no provision is made for reasonable belief.¹⁸⁷ The language in the Regulation S rules, then, does not seem to apply a look through provision for Category 1 securities but may apply one for Category 2 and Category 3 securities.¹⁸⁸

Forcing issuers of Category 1 securities to look through nominee entities seems anomalous from a policy perspective. Under Regulation S, issuers of Category 1 securities are allowed to sell on an established foreign securities exchange or a designated offshore securities market without knowledge of who the buyer on the other side may be. Therefore, to ask issuers and sellers of Category 1 securities to pursue the identity of a beneficial buyer through a nominee company does not appear justifiable. So long as the barrier against solicitation remains in place, there is no need for a look through requirement.

A look through requirement for issuers and distributors would only be justifiable if the Commission wished to prevent U.S. residents from participating in primary offerings that are not made on an established foreign securities exchange. The emphasis is on primary offering because U.S. residents may partake in secondary market transactions of the same securities through a designated foreign securities market. Preventing U.S. residents from participating in such primary offerings makes sense only if purchases on secondary markets are deemed much less risky than purchases on primary markets. Preventing U.S. investors from purchasing on the primary market, however, is an odd result because, usually, the prices on the secondary market are much higher. There are gains to be made by purchasing on the primary market. This is because prices on the primary market often have not been set by "deep liquid markets where rational [or irrational] expectations . . . have been incorporated."¹⁸⁹ Under such circumstances, underwriters often underprice a distribution for reasons that

¹⁸⁷ Commodity and Securities Exchanges, 17 C.F.R. § 230.903(b) (2002). This is because the reasonable belief provision comes from the definition of offshore transaction, which is not implicated in the Rule 903(b) prohibition on sales to U.S. persons during the distribution compliance period. Commodity and Securities Exchanges, 17 C.F.R. § 230.902(h)(ii)(A) (2002); Commodity and Securities Exchanges, 17 C.F.R. § 230.903(b) (2002). Alternatively, for resales, while the definition of offshore transaction is again not implicated, the restriction on trading Category 2 and 3 securities involves knowledge; sellers may not have knowledge as to the residence of the U.S. person if they only see the nominee entity. Commodity and Securities Exchanges, 17 C.F.R. § 230.904(b) (2002). Therefore, resales through nominee entities may be allowed even for Category 2 and 3 securities. Category 3 securities, however, are specifically brought under the auspices of Rule 144, so such a reading would not make sense. Commodity and Securities Exchanges, 17 C.F.R. § 230.905 (2002).

¹⁸⁸ At the very least, the look through provision for Category 1 may not be as demanding as the one implied by the language in the enacting release because sellers can claim reasonable belief.

¹⁸⁹ Scott, *supra* note 8, at 71.

are beyond the scope of this article. Regardless of the reasons for underpricing, there is no reason to punish U.S. residents investing abroad by preventing them from partaking in these gains.

Issuers of Category 2 and 3 securities, of course, must prevent the securities from being transferred to U.S. persons within the distribution compliance period, so forcing them to look through nominee entities during the distribution compliance period seems reasonable and necessary. Furthermore, such a requirement would be in accord with the lack of a reasonable belief exemption in the distribution compliance period requirements of Rule 903, as discussed above. This would result in two different look-through standards based on categorization, which does not seem unreasonable given the other category-based differences in requirements.

b. *The Commission's Recent Announcements on Nominee Entities*

The Commission's recent pronouncements on nominee entities in the context of foreign private issuers should be considered. Recently, the Commission revised the definition of "foreign private issuer" in Rules 405 and 3b-4.¹⁹⁰ The reason was that "the increased prevalence of offshore nominees and custodial accounts has made record ownership less meaningful for purposes of determining [U.S.] ownership."¹⁹¹ Therefore, the new definitions require issuers to look through nominees in order to determine the beneficial owners of their stock.¹⁹² The Commission felt that this would make counts of U.S. shareholders more accurate for purposes of determining whether or not a company "is entitled to the accommodations available to foreign private issuers."¹⁹³

Having required issuers to look through nominees, however, the Commission softened its stance. Concerns were raised that this requirement "would create substantial burden for companies that trade in many different markets" and would cause "widely held companies . . . to devote significant effort and expense in determining beneficial ownership in many jurisdictions where the likelihood of finding [U.S.] owners is small."¹⁹⁴ The

¹⁹⁰ International Disclosure Standards, Exchange Act Release Nos. 33-7745, 34-41936 (Sept. 28, 1999). Incidentally, the Commission, in promulgating the new merger rules, followed the new definition of foreign private issuer. See Cross-Border Tender and Exchange Offers, Business Combinations and Rights Offerings, Exchange Act Release Nos. 33-7759, 34-42054 (Oct. 22, 1999). See also Rule 800(h)(3).

¹⁹¹ International Disclosure Standards, Exchange Act Release Nos. 33-7745, 34-41936 (Sept. 28, 1999).

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *Id.*

Commission, therefore, limited the look through requirement to nominees based in the United States, in the issuer's home jurisdiction, and in the primary trading market for the issuer's securities.¹⁹⁵ Furthermore, if the issuer, "after reasonable inquiry," cannot determine the residency of such holders, the issuer may assume that the holders "are residents of the jurisdiction in which the nominee has its principal place of business."¹⁹⁶ The Commission, notably, retained the requirement of look-ing through all nominees regardless of location for purposes of Rule 12g3-2(a).¹⁹⁷ It also did not provide any exception based on reasonable inquiry for Rule 12g3-2(a).¹⁹⁸ Rule 12g3-2(a) exempts issuers with less than 300 U.S. shareholders from the registration requirement of Section 12(g). The Commission provided no explanation as to why the look through requirement was not softened for Rule 12g3-2(a).¹⁹⁹

There are, thus, two different look through requirements. For purposes of determining foreign private issuer status, issuers only have to look through nominees in certain geographic locations. For Rule 12g3-2(a) purposes, issuers must look through all nominees regardless of location. Given these two differing standards, there is no certainty as to the extent to which issuers might be required to look through nominees for purposes of Regulation S. The purposes behind the two rules appear to be similar; both the foreign private issuer rules and the Rule 12g3-2(a) requirement stem from the purpose of disclosing information. Rule 12g3-2(a) exempts companies with fewer than 300 U.S. shareholders from providing informa-

¹⁹⁵ *Id.* For purposes of the merger rules, companies must look through nominees "located in the United States, the subject company's jurisdiction of incorporation or that of each participant in a business combination, and the jurisdiction that is the primary trading market for the subject securities." Rule 800(h)(3).

¹⁹⁶ Rule 3b-4 and Rule 405. The same exception applies to the merger rules. Rule 800(h)(4).

¹⁹⁷ See Rule 12g3-2(a). There is no instruction concerning limiting the requirement as there is following Rules 3b-4 and 405. Furthermore, there was no indication in the enacting release concerning limiting the look through requirement of Rule 12g3-2(a). See International Disclosure Standards, Exchange Act Release Nos. 33-7745, 34-41936 (Sept. 28, 1999).

¹⁹⁸ See *id.*

¹⁹⁹ One possible explanation for retaining the strict look through requirement for Rule 12g3-2(a) is that the penalties for not meeting the conditions of this rule are not particularly harsh. Foreign private issuers who do not meet the Rule 12g3-2(a) test may still exempt themselves from § 12(g) registration requirements by furnishing the Commission with copies of the documents that they have already filed for purposes of their home country regulations, that they have filed with a stock exchange, or that they have provided to their security holders. Rule 12g3-2(b); see also Joel Seligman, *The Mandatory Disclosure System and Foreign Firms*, 4 PAC. RIM L. & POL'Y J. 807, 824 (1995). Therefore, if one meets the foreign private issuer definition, with the softened look through requirement, and then one fails the Rule 12g3-2(a) test or merely chooses not to take on the challenge of doing a strict look through, the default position of complying with Rule 12g3-2(b) is not particularly costly.

tion to the public as required by section 12(g).²⁰⁰ Foreign private issuers are often exempt from U.S. securities laws aimed at providing information to the public.²⁰¹ With such similarities underlying the two rules, determination of which rule should be applied to any look through requirement of Regulation S is uncertain at best.²⁰²

From a policy perspective, there does not appear to be a need for Category 1 securities issuers to look through nominees. As mentioned above, U.S. investors can reach out and purchase directly on an established foreign securities exchange where issuers are not required to determine the identity of the party buying the securities. Of course, so long as there is no advertisement or solicitation, U.S. residents are unlikely to approach such foreign exchanges, and those who do know about these Category 1 securities have likely done sufficient research to protect themselves. They certainly would not expect to be protected by U.S. securities laws. Similarly, those who invest through a nominee company still have to find out about Category 1 securities despite the prohibition against directed selling efforts into the United States. Those who do find out and those who are sufficiently sophisticated to use nominee companies abroad are likely to have sufficient knowledge concerning foreign securities to protect themselves. Furthermore, those who reach out into foreign jurisdictions through foreign nominees are unlikely to expect the protections of the U.S. securities laws. Therefore, given the theoretical underpinnings of Regulation S, there does not appear to be any need for issuers to look through nominees when issuing Category 1 securities.²⁰³

²⁰⁰ Rule 12g3-2(a) and § 12(g) of the Exchange Act.

²⁰¹ One example would be Rule 801 and 802, where foreign private issuers engaging in a merger are exempt from the registration requirements of § 5 of the Securities Act. Another example, of course, would be Rule 12g3-2(b), referred to in note 199, where foreign private issuers can be exempted from the § 12(g) Exchange Act registration requirements by furnishing the Commission with documents that have already been produced for other purposes.

²⁰² Part IV(E) presents a situation that supports the adoption of the Rule 12g3-2(a) approach.

²⁰³ The policy analysis for resales under Rule 904 would be exactly the same with two additions. Both additions support the idea of no look through requirements. First, for resales, the distribution is likely to have been concluded, so the threat of a flood of unregistered securities into U.S. hands is smaller than that faced during the distribution. Second, those reselling securities, including dealers, may have less capacity for investigating the purchasers than distributors and issuers have. This is because distributors and issuers are likely to be handling larger quantities of securities, so they can better bear the costs of investigation.

IV. PERSPECTIVES AND PRACTICES ON THE GROUND

Part III of this article presented an analysis of the issues and problems surrounding the purchase of foreign Category 1 securities by U.S. retail investors. This part of the article seeks to examine the difficulties and restrictions surrounding the issue from the perspective of professionals involved in this field. In particular, this part investigates how professionals respond to the restrictions discussed in Part III when dealing with U.S. retail investors seeking foreign securities. While the analysis above focused on Category 1 securities, the discussion here includes some discussion of Category 2 securities because, as a practical matter, the two categories appear to meld together in practice.²⁰⁴

A. Interviews

Information for this part of the article was gathered primarily through telephone interviews.²⁰⁵ These interviews present a glimpse of current market practices and cannot be taken as being wholly representative of the industry. The interviews do, however, provide concrete examples of actions taken by market professionals that can be contrasted with the analysis developed in Part III.

The interviews include a number of different perspectives on the issues presented in Part III. The interviewees for this article were representatives in the legal departments of two large U.S. financial companies, the outside legal counsel for a securities exchange, and an executive at a recent issuer. To maintain the interviewees' anonymity, no names will be used.

Some information on the parties discussed in this article is in order. The two financial companies examined both provide a broad range of financial services, including portfolio management and retail brokerage services.²⁰⁶ The securities exchange discussed in this part is an electronic exchange based in Europe.²⁰⁷ The issuer investigated in this article made its

²⁰⁴ By contrast, all individuals interviewed treated and discussed domestic equity securities, included in Category 3, as completely separate and distinct from other securities traded abroad.

²⁰⁵ The interviews were conducted with the aid of Professor Howell Jackson. Professor Howell E. Jackson is the Finn M. W. Caspersen and Household International Professor of Law at Harvard Law School. His support was invaluable in the writing of this article.

²⁰⁶ For citation purposes, the financial companies will be referred to as F1 and F2. Their representatives who were interviewed will be referred to as F1-1, F2-1, and F2-2 respectively. Two individuals were interviewed at F2.

²⁰⁷ For citation purposes, the interviewee who provided information about this exchange will be referred to simply as "legal counsel for the exchange."

offering as part of a merger transaction from which U.S. resident shareholders were specifically excluded.

B. Market Practices

Some general information about the retail market for foreign securities emerged from the interviews. This information provides helpful background for the analysis presented below.

United States retail interest in foreign securities is apparently extremely small. One of the financial institutions examined conducts over 100,000 trades each day for its retail customers.²⁰⁸ Of this number, only about fifty concern foreign securities.²⁰⁹ Despite the relatively small volume, the company is fully equipped to handle foreign trades and regularly does so for customers who request such transactions.²¹⁰ Indeed, this is an area of business that the company is trying to grow.²¹¹

The interviews indicate that foreign exchanges are aware of Regulation S restrictions and provide some tracking of restricted securities in order to comply with Regulation S. The exchange discussed in this article designates its restricted securities with a marker attached to the securities' trading symbols.²¹² Thus, all member firms trading in a marked stock know that the stock is restricted for Regulation S purposes and should not be sold to or purchased for U.S. persons.

The interviews also indicated that there are alternatives to the traditional trading formats presented in Figure 2. Apparently, one of the financial companies represented in the interviews sometimes makes markets in foreign securities.²¹³ This market-making activity is apparently carried out in a form similar to pink sheet transactions that do not trigger Exchange Act reporting requirements for issuers.²¹⁴ Such markets are subject to regulatory requirements the details of which are beyond the scope of this article. Commercial information services, however, are apparently sensitive to these regulatory concerns and publicize the information required by such

²⁰⁸ Interview with F2-1.

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ E-mail from F2-2. During the phone interview with F2-1, however, he stated that F2 does not market trades in foreign securities to its retail clients but only provides such services when requested.
Interview with F2-1.

²¹² Interview with legal counsel for the exchange.

²¹³ Interview with F1-1.

²¹⁴ *Id.*

regulations.²¹⁵ Therefore, an alternative to purchases on a foreign market appears to be purchases through domestic market makers.

C. *A View From the Financial Institutions*

From the perspective of those working in the financial institutions, there appear to be few if any regulatory prohibitions on retail investment in foreign securities. None of the individuals interviewed at financial institutions appeared to think of Regulation S as a major issue, and all of these individuals were lawyers in their respective legal departments.

Of the two financial companies discussed in this article, the one that does not make markets in foreign securities relies entirely on other brokers to execute its foreign transactions.²¹⁶ When an individual investor contacts the institution to buy a foreign security, the institution contacts another broker-dealer to execute the transaction.²¹⁷ The customer will deal strictly with the first institution, but the transaction will be executed by another broker-dealer, perhaps one with an inventory of foreign stocks.²¹⁸ This first institution does not itself carry foreign stocks and serves merely as a conduit. For this reason, perhaps, its representatives in this area need not concern themselves with Regulation S as other brokers were handling the execution of the transactions. Furthermore, since the institution is registered with the Commission, the restrictions of Rule 15a-6 are not a concern, and advertising would not be problematic.²¹⁹

Interestingly, the company that makes markets in foreign securities also was not particularly concerned about Regulation S. The company's internal system keeps track of any public distributions with which it is involved.²²⁰ Therefore, any employee about to enter a transaction will know whether the security to be transacted has been recently issued with the company's assistance.²²¹ There was uncertainty on the part of this company's representative as to whether or not her company also tracked other distributions that were publicized.²²² In general, if the market-making company knew about

²¹⁵ *Id.*

²¹⁶ Interview with F2-1.

²¹⁷ *Id.*

²¹⁸ E-mail from F2-2.

²¹⁹ Part III(D) of this article discusses the restrictions of Rule 15a-6.

²²⁰ Interview with F1-1.

²²¹ *See id.*

²²² *Id.* Therefore, it is entirely possible that the company tracks only its own distributions and not those made by other companies. This may be because, for Category 2 securities, the issuer and its distributors cannot sell to a U.S. person within the distribution compliance period of forty days. Commodity and Securities Exchanges, 17 C.F.R. § 230.903(b)(2)(ii) (2002). If this company were

a recent distribution, then the matter would be investigated further.²²³ The interviewee, however, was not aware of any specific internal rule as to when such transactions would be executed and when they would not.²²⁴ Since this company does not have a blanket prohibition on retail transactions, presumably Category 1 transactions would be allowed. There would be no reason at all to allow a Category 2 or Category 3 transaction and disallow a Category 1 transaction.

Neither of the two financial institutions discussed any problems relating to Section 4(3).²²⁵ Presumably, all transactions involving these institutions would be broker's transactions within the Section 4(4) exemption.²²⁶ One of the companies explicitly does not market their foreign trading capabilities, so there should be no problem fitting under the Rule 144(g) allowances.²²⁷ The other institution's marketing strategies concerning foreign securities were not discussed, but so long as no specific securities are marketed, there should not be a problem fitting under Section 4(4)'s allowance of general advertising of brokerage services.

These results are generally consistent with the analysis of Part III. Part III concluded that unsolicited interest in foreign securities is not subject to any regulatory restrictions. In the present case, neither of the financial institutions investigated appear to be particularly concerned in a regulatory sense with retail investors who inquire about foreign securities. While one institution tracks certain distributions in which it has participated, it is not clear that all recent distributions are tracked. There appears to be no barrier in practice preventing an investor located in the United States from purchasing foreign Category 1 securities through a registered U.S. broker.

involved in a distribution, it may be considered a distributor and would not be allowed to sell to a U.S. investor. For Category 2 resales, dealers are also prohibited from knowingly selling to a U.S. person. Commodity and Securities Exchanges, 17 C.F.R. § 230.904(b)(1)(i) (2002). Under the broad definition of dealer incorporated by the Securities Act, the company, acting in its capacity as a broker, may be deemed a dealer, but it would probably be considered the buyer in the transaction since it would be representing a retail purchaser. In another interview, a lawyer raised the possibility that a distributor may become a market maker or dealer upon completion of the distribution. Interview with legal counsel for the exchange. In such a situation, sales by the dealer may be restricted, but the lawyer thought that there should be some accommodation made so that such a dealer would fall under Rule 904 and not Rule 903. Interview with legal counsel for the exchange.

²²³ Interview with F1-1.

²²⁴ *Id.*

²²⁵ See interviews with F1-1 and F2-1.

²²⁶ Part III(B) of this article discusses the effects of § 4(3) and 4(4) on Category 1 offerings.

²²⁷ Interview with F2-1.

D. *Analysis of an Electronic Exchange*

The electronic exchange examined in this article does not appear to impose any special restrictions on Category 1 trading. Therefore, U.S. investors should be able to purchase such securities by contacting a European dealer that is a member of the exchange.²²⁸ The exchange appears only to impose restrictions on the trading of Category 3 securities for Regulation S compliance purposes.

The exchange has been designated as an offshore securities market and bases its primary distribution practices on published Commission no-action letters. The exchange is designated as an offshore securities market pursuant to Rule 902(b) so that resales made pursuant to Rule 904 on the exchange would be considered offshore under Rule 902(h)(1)(ii)(B)(2).²²⁹ With respect to primary offerings made pursuant to Rule 903, the situation is a bit more complicated because of the Category 3 requirements applied to U.S. equity securities.²³⁰ In particular, Rule 903(b)(3)(iii)(B)(1) requires that purchasers certify that they are not U.S. persons. According to legal counsel for the exchange, the identity of a purchaser on an electronic exchange is impossible to determine. For this aspect of its practices, the exchange relies on the protocol established by published Commission letters. In such situations where purchasers cannot be identified, an important condition imposed by the Commission is the requirement that all restricted securities under Rule 905 be designated with an additional marker attached to their trading symbols.²³¹ Furthermore, the significance of this marker must be publicized, and all member firms are expected to act appropriately when trading one of these marked stocks.²³² The exchange has followed such procedures in its practices.²³³

As a result of these procedures and of being designated an offshore securities market, trades falling within the Regulation S safe-harbor may occur on the exchange. United States retail investors, so long as they contact a member firm, can trade on this exchange. With the exception of the marked Category 3 securities, brokers are not restricted from making

²²⁸ All member firms of this particular exchange must be European.

²²⁹ To preserve anonymity, the no-action letter so designating the exchange is not cited.

²³⁰ Interview with legal counsel for the exchange.

²³¹ European Association of Securities Dealers Automated Quotation N.V./S.A., SEC No-Action Letter, available at 1999 SEC No-Act. LEXIS 652 (July 27, 1999). Incidentally, this letter, relied upon by the exchange, applies only to non-reporting U.S. companies. See *id.*

²³² *Id.*

²³³ Interview with legal counsel for the exchange.

purchases on behalf of U.S. investors on the exchange, and similarly issuers, distributors, and others may sell through the exchange in offshore transactions. Interestingly, Category 2 securities, unlike their Category 3 counterparts, are not tracked by any designation attached to their trading symbols.²³⁴ The Commission appears not to require such tracking.²³⁵ Thus, there is no way to identify a Category 2 issuer during its distribution compliance period. There appear to be no limits, then, to U.S. retail purchases of Category 2 securities. This would, of course, imply that there are also no limits to U.S. retail purchases of Category 1 securities.

The result with respect to Category 1 securities confirms the analysis of Part III. In Part III, the article concluded that Regulation S did not impose any restrictions on U.S. retail investors purchasing Category 1 foreign securities so long as the securities were purchased offshore.²³⁶ In this situation, the exchange examined is a designated offshore securities market; while Regulation S does not define established foreign securities exchange, a no-action letter relied upon by the exchange indicates that it likely qualifies for such status.²³⁷ Accordingly, U.S. investors may freely trade in Category 1 securities.

The result of this regime with respect to Category 2 securities is more problematic. While Category 2 securities were not discussed in detail in Part III, the regime discussed here presents an interesting opportunity for analysis. According to Rule 903(b)(2)(ii), no offer or sale may be made by an issuer or distributor to U.S. persons within a forty-day distribution compliance period. As noted previously, however, one cannot identify the purchaser of a security on an electronic exchange. Therefore, it is unclear as to how distributors selling securities on the exchange in question can avoid selling to U.S. persons. Without a marker to prevent other member firms from buying on behalf of U.S. individuals, there appear to be no restrictions on purchases by U.S. persons.

The solution to this dilemma appears to lie in the common practice of issuers on this particularly exchange. Apparently, issuers sell their securities to institutional investors who often, though not always, immediately sell the securities on the exchange.²³⁸ Legal counsel for the exchange seemed to imply that the securities were sold at a price very close to the primary market-offering price. In Europe, these institutional investors are not

²³⁴ *Id.*

²³⁵ See European Association of Securities Dealers Automated Quotation N.V./S.A., SEC No-Action Letter, available at 1999 SEC No-Act. LEXIS 652 (July 27, 1999).

²³⁶ See Part III(A) of this article.

²³⁷ See *id.*

²³⁸ Interview with legal counsel for the exchange.

considered distributors, as they would be if the underwriter definition in Section 2(a)(11) of the Securities Act were invoked.²³⁹ Therefore, their actions fall under the resale provision of Rule 904. Because Rule 904(b)(1)(i) implements a knowledge requirement, unwitting sales to U.S. persons due to the anonymity of the exchange is not prohibited by Regulation S.²⁴⁰

That the Commission has addressed anonymity problems with respect to electronic exchanges in a published no-action letter is of importance.²⁴¹

²³⁹ *Id.* This raises an interesting choice-of-law question, a full exploration of which is beyond the scope of this article. Intuitively, however, since Regulation S is a U.S. law promulgated under the Securities Act, the definition of underwriter found in § 2(a)(11) of the Securities Act should apply. That would make these institutional investors distributors by virtue of Rule 902(d), which states that "Distributor" means any underwriter, dealer, or other person who participates . . . in the distribution . . ." Strict adherence to this reading, however, leads to the statutory mess that follows.

According to Rule 902(f), the distribution compliance period begins "when the securities [are] first offered to persons other than distributors . . . or the date of closing of the offering, whichever is later." In most cases, this would appear to indicate that the distribution compliance period would not begin until after the closing of the offering. Mr. Greene's treatise on foreign securities transactions, however, seems to indicate that, "except in delayed offerings," the later date would be the date the securities are first offered to the public, so the distribution compliance period "is no longer tied to the completion of the distribution of securities." Greene, et al., *supra* note 50, at §§ 5.02-03, 5-17. This may be because the distribution, as noted in the text, is deemed to be complete after the securities are transferred to the institutional investors. Under the U.S. interpretation of underwriter, however, the distribution is not complete until after the institutional investors have completed their sales to the public. Since these investors are usually not bound to sell to the public, completion of the distribution may be difficult to define. Even so, under U.S. rules, the distribution compliance period should not start until the institutional investors have completed their sales.

Upon completion of the distribution, a new dilemma arises. The standard U.S. interpretation of distribution includes any sales by distributors or issuers. Therefore, sales during the distribution compliance period by issuers or distributors would constitute a new offering or distribution. Perhaps, then, no distributors can ever make sales as distributors within the distribution compliance period because such sales would become their own Regulation S distribution. If this is so, then one need not worry about excluding U.S. investors from sales made during the distribution compliance period as mandated by Rule 903(b)(2)(ii). No such sales would exist. Of course, this interpretation also makes Rule 903(b)(2)(ii) unnecessary. That does not seem plausible.

To give Rule 903(b)(2)(ii) meaning, two possible interpretations of this dilemma are offered. The first is that distributors and issuers can make sales after the end of the distribution without those sales becoming a new distribution. The second explanation is that the distribution compliance period begins with the public distribution of the securities to the institutional investors. In either scenario, U.S. interpretations of law are not followed.

²⁴⁰ Rule 904(b)(1)(i) states that resales by a dealer within the distribution compliance period must not be made to any person that the dealer "knows" to be a U.S. person. Clearly, dealers cannot identify those making purchases on the exchange and cannot knowingly sell to a U.S. person. Resales by non-dealers do not appear to be limited at all by the distribution compliance period and, barring other applicable exemptions to the Securities Act, are limited only to offshore transactions without directed selling efforts. *Commodity and Securities Exchanges*, 17 C.F.R. § 230.904(a) (2002).

²⁴¹ See European Association of Securities Dealers Automated Quotation N.V./S.A., SEC No-

The Commission's actions would indicate that there is no concern here with respect to Category 2 securities. This could be because sales of Category 2 securities to U.S. persons are not violations of Regulation S or because the likelihood of flowback is extremely low.²⁴² The former explanation is unlikely given the explicit language of Rule 903(b)(2)(ii). The latter is more plausible, but there are no Commission pronouncements to support this view.

With respect to the other restrictions on U.S. investment in Category 1 securities discussed in Part III, legal counsel for the exchange appeared to have no concerns. Specifically, when asked about the potential Section 4(3) forty-day limitation, legal counsel stated that he had never considered it.²⁴³ As an initial reaction, however, he thought that imposing a Section 4(3) limitation on such transactions would be inappropriate if not wrong. He believed that the purpose of Regulation S was to give clarity to the scope of U.S. jurisdiction over overseas offerings; therefore, hunting for more restrictions beyond Regulation S would be counter to the regulation's explicit goals. Furthermore, with respect to Rule 15a-6 broker-dealer registration requirements, legal counsel for the exchange seemed to believe that it is not unusual for U.S. investors to open accounts with European brokers, so compliance with U.S. rules must not be particularly problematic.²⁴⁴

These conclusions are consistent with the analysis of Part III provided that all restrictions on solicitation by brokers are met. The interview with legal counsel for the exchange, however, did not address solicitation, so the possibility exists that the restrictions may be less stringent than the analysis in Part III indicate.

E. *Case-Study of an Issuer*

This article uses the experience of a merger transaction to examine the perspective of an issuer on Regulation S offerings.²⁴⁵ While prior sub-

Action Letter, available at 1999 SEC No-Act. LEXIS 652 (July 27, 1999).

²⁴² Part III(E)(1) of this article discusses the central role that flowback plays in the rationale and structure of Regulation S.

²⁴³ The effects of § 4(3) on Category 1 offerings is discussed in Part III(B) of the article.

²⁴⁴ The implications of Rule 15a-6 on foreign offerings is detailed in Part III(C).

²⁴⁵ While interviews with the representative of the new company provided the most important information on the issuer's perspective and decision-making process, much information on the transaction was gathered from public sources. Financial information on the acquired company was available through filings with the Commission as were many merger documents. Filings were found via Global Access, an electronic service. Some information was found via Bloomberg's electronic service as well. Professor Howell Jackson provided information on American Depositary Shares ("ADSs") of

sections involved general responses to hypothetical requests and transactions, this subsection investigates an actual, consummated merger. Therefore, this subsection necessarily includes more factual details so readers will have a full understanding of the issuer's concerns.

The company formed in the merger will be called Newco, and it is incorporated in the United Kingdom and traded on the London Stock Exchange. It was formed through the merger of two companies, termed P and T for purposes of this discussion. P was incorporated in the United Kingdom, and T was incorporated in the Netherlands. T's stock was traded in Amsterdam and in New York as American Depositary Shares ("ADSs").²⁴⁶ The merger took place in the summer of 1999. Under the terms of the transaction, a fixed number of P shares were issued for each T share.²⁴⁷ United States shareholders were not included in the offering, and a cash offer for outstanding T shares was made in July of 2000.²⁴⁸

1. T SHARES

A brief description of the T shares exchanged as part of this transaction is in order. For purposes of this article, T shares will be discussed under two labels. Amsterdam shares refer to T shares that are traded on the Amsterdam exchange, and New York shares refer to ADSs that represent T shares and that are traded in New York.²⁴⁹ At the time of the transaction, most T shares were held as Amsterdam shares.²⁵⁰ Additionally, at the time of the transaction, T only knew the identity of approximately 75% of the beneficial holders of its stock. The remaining 25% of shareholders held their stock through nominee entities. According to Dutch depository law,

the acquired company that was originally obtained through the New York Stock Exchange. The executive interviewed originally worked at the acquired company prior to the merger. For citation purposes, he will be referred to as the "Newco executive."

²⁴⁶ T actually had two classes of stock. The first was wholly owned by a foreign, controlling company. Forty-eight percent of the second class of stock was also owned by the controlling company, and the remaining 52% of this second class of stock was owned by the public. This article is only concerned with U.S. shareholders who owned the second class of T stock, so references to T stock refer solely to this second class.

²⁴⁷ Presumably, after the transaction, the P shares were renamed Newco shares.

²⁴⁸ Interview with the Newco executive. No press release concerning this cash offer was found on Newco's web site, though a press release stating Newco's intent to make a cash offer was posted on the web site.

²⁴⁹ Each T ADS represented one Amsterdam share.

²⁵⁰ According to the Newco executive interviewed, this was true not only for U.S. holders, as described below, but also for holders in the United Kingdom and in various European countries, particularly Germany.

T could not seek to look through the nominee for the identity of the beneficial holder.²⁵¹

When T's shares were first offered in the United States, nineteen million shares were registered. The number actually issued, however, is unclear. According to data from the New York Stock Exchange, by the end of 1997, there were just over 5 million New York shares left. One year later, that number was down to 1.9 million shares. The Newco executive interviewed estimated that, at the time of the transaction, there were still approximately 1.5 million New York shares. Thus, there was a clear trend of moving away from holding T stock in the form of New York shares.

Interestingly, the Newco executive believed that the proportion of U.S. shareholders actually increased over this period. Initially, when the New York shares were first offered, U.S. shareholders held approximately 35% of the distributed shares. The interviewee believed that the proportion had increased to 40% by the time of the transaction. Apparently, many U.S. investors were purchasing T shares directly in the form of Amsterdam shares. The interviewee believed these investors to be mostly institutional but was not sure about the exact composition. As noted above, Dutch depositary laws prevented T personnel from looking through nominees and identifying beneficial shareholders.²⁵²

The New York shares remaining at the time of the transaction were held by a core group of investors that consisted of two to three institutional investors and a handful of retail investors.²⁵³ During the public offering, some retail investors had participated.²⁵⁴ The Newco executive felt, however, that U.S. retail interest had been limited after the offering. The New York shares were traded at a rate of approximately one hundred shares per day. The Amsterdam shares, in contrast, had a trading volume of approximately 200,000 shares per day. Thus, the center of activity for T shares was clearly Amsterdam.

By the end of the transaction, approximately 98.5% of outstanding T shares had been tendered for exchange. This left between 600 and 700 thousand shares outstanding. The Newco executive stated that, since the beginning of 2000, some of these shares have slowly been redeemed. He did not specify as to whether or not they have been exchanged for Newco stock or for cash. By early summer of 2000, only 250,000 shares of T stock remained outstanding. While some of these are New York shares, some of them are also Amsterdam shares. The Newco executive attributed these

²⁵¹ Interview with Newco executive.

²⁵² *Id.*

²⁵³ *Id.*

²⁵⁴ *Id.*

Amsterdam shares to Dutch holders who, for a variety of reasons, have not exchanged their shares.²⁵⁵ He would not speculate as to whether or not these Amsterdam shares might have been held by U.S. retail investors.

2. DECISION NOT TO REGISTER P SHARES

The decision not to register the P shares sheds light on the foreign companies' perceptions of U.S. investors and of Regulation S. This decision was made early in the process and was based on three reasons.²⁵⁶

First, both companies feared the possibility of a hostile bidder, so the merger had to proceed relatively quickly. T seemed to be under the impression that the shareholder vote would have to await the Commission's approval of the transaction.²⁵⁷ The Newco executive stated that he felt registration in the United States would have added an additional three weeks to the period between the announcement of the merger and the receipt of shareholder approval.

Second, T believed that most of its U.S. shareholders were institutional investors with offshore offices.²⁵⁸ This would make them non-U.S. persons for purposes of Regulation S, and they would be allowed to participate in the transaction. In short, T believed that only a small proportion of its shareholders would be unable to participate in an unregistered transaction.²⁵⁹

Third, the addition of a registered U.S. tranche would have added to the cost and complexity of the transaction. While this option was never priced, the dominant belief at T was that the benefit of a U.S. tranche would be too small to justify its price, particularly given T's belief that most U.S. shareholders would be able to participate in the unregistered offering.²⁶⁰

As shown below, these perceptions appear to be mostly correct.

3. U.S. PARTICIPATION IN THE OFFERING

U.S. participation in the public offering of P shares was prohibited by Regulation S. P shares had no U.S. trading market, so they were classified as Category 1 securities. The restrictions that applied, then, were the prohibition against directed selling efforts into the United States and the

²⁵⁵ The Newco executive's list of reasons included Dutch holders who have remained unaware of the merger, who have died, and who have simply forgotten about their shares.

²⁵⁶ Interview with Newco executive.

²⁵⁷ See *id.*

²⁵⁸ *Id.*

²⁵⁹ *Id.*

²⁶⁰ *Id.*

prohibition against making offers or selling shares into the United States. As a result, T shareholders resident in the United States could not directly exchange their T shares for P shares regardless of whether they held their T shares in the form of Amsterdam shares or New York shares.

By the end of the transaction, the number of outstanding T ADSs totaled between 250,000 and 350,000.²⁶¹ This is in contrast to the 1.5 million ADSs held by U.S. shareholders at the beginning of the transaction. The question, then, is how over 1 million ADSs were exchanged despite the Regulation S prohibition against selling into the United States. Moreover, the 40% of shares held by U.S. investors also could not have been exchanged unless those U.S. investors traded from offshore offices or otherwise resided abroad. Under the analysis of Regulation S developed above, U.S. shareholders are only allowed to participate in an offshore primary offering through an established foreign securities exchange.²⁶² In the present situation, the transaction of T shares for newly issued P shares did not occur through an exchange.

Most U.S. institutional shareholders, who held shares in the form of either New York shares or Amsterdam shares, transferred their shares offshore in order to participate in the offering.²⁶³ Those shareholders who had a branch office in a foreign country could transfer their shares to that branch. They would no longer be considered as resident in the United States, and they could exchange their shares as part of the transaction.²⁶⁴

For those U.S. institutional investors who did not have a foreign branch, there was the option of nominee companies.²⁶⁵ According to the Newco executive, at least one or two U.S. institutional shareholders transferred their T shares to nominee accounts offshore. From there, if the shares were held in the form of New York shares, they would be exchanged for Amsterdam shares. At that point, all Amsterdam shares would be redeemed for P shares. Furthermore, some institutional investors were gently steered towards "brokers [who were] not party to the transaction" but who knew how to transfer U.S. shares offshore.²⁶⁶ Additionally, T also received numerous telephone calls from angry U.S. investors. United States investors that contacted T directly were told that U.S. law prohibited any contact with them and that they should seek professional investment advice.²⁶⁷

²⁶¹ *Id.*

²⁶² This analysis was developed in Part III(A) of this article.

²⁶³ Interview with Newco executive.

²⁶⁴ The statutory analysis for this outcome was established in Part III(A) of this article.

²⁶⁵ The issues surrounding nominee entities are discussed in Part III(E)(3) of this article.

²⁶⁶ *Id.*

²⁶⁷ *Id.*

4. REGULATION S AND ITS POLICIES

This case poses two issues. First, the case seems to push at the technical limits of what is sanctioned by Regulation S. Second, this case presents an opportunity to study the effectiveness of Regulation S in promulgating the policies discussed above.²⁶⁸

a. *Application of Regulation S*

The way U.S. investors handled the merger transaction raises several Regulation S questions. These issues include the use of a branch office, the use of nominees, and the possible brokers' solicitations.

As described above, some U.S. institutional investors moved their T shares to offshore offices and participated in the exchange transaction through these offices. This appears to have been in accord with Regulation S. Authorized employees are allowed to buy shares for a company abroad, and the transaction will not be deemed a sale to a buyer in the United States.²⁶⁹ In the present situation, the offices of U.S. institutional investors abroad must have had authorized employees to make trades for the investors, so the transactions are likely to have been permissible under Regulation S.

The use of nominee accounts presents a slightly more complicated issue. Indeed, it presents multiple issues. First, there is the problem of knowledge that a buyer is in the United States. The executive at T knew of certain U.S. institutional investors who had shifted their stocks to offshore nominee accounts. Regardless of whether or not P has a duty to look through the nominee, one pertinent question is whether T must impart that knowledge to P. The two companies are, after all, merging. From P's perspective, the issue is whether P may be charged with knowledge of a U.S. buyer because T possessed that knowledge. The rules of Regulation S do not present an answer to this situation. From a policy perspective, it seems that a company, such as T, that has U.S. shareholders and is participating in an unregistered offering which directly affects its shareholders should be held responsible for preventing any breaches of Regulation S. Any solution, at this point however, would be purely speculative.

²⁶⁸ The policy analysis can be found in Part III(E)(1).

²⁶⁹ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

This outcome is discussed in Part III(A) of this article.

The second problem that arises with the use of nominees is that of whether or not an issuer should be required to look through nominees.²⁷⁰ In this situation, two sets of investors held shares through nominee entities. First, institutional investors transferred their holdings to offshore nominee companies; second, there is a high probability that retail investors who purchased Amsterdam shares did so through nominee entities.²⁷¹ Therefore, this case indicates that the Rule 12g3-2(a) method of looking through nominees is more appropriate.²⁷² In the context of this merger transaction, all shareholders want to participate.²⁷³ Therefore, if the issuer is only required to look through certain nominees, as is the case under the foreign private issuer rules, then shareholders, both institutional and retail, will specifically choose nominees in countries that are not subject to the look through requirement. While the issue of whether or not issuers must look through nominees remains ambiguous, this situation would favor using the look through requirement of Rule 12g3-2(a) if a requirement is imposed.

The merger transaction also highlights the distinction between purchasing on the primary market as opposed to the secondary market. U.S. investors who sell their T shares on the Amsterdam exchange and buy Newco shares on the London Stock Exchange have effected a substantially similar outcome but have not participated in the transaction. This is no different from the mandatory cash out that is imposed on U.S. investors who do not use nominee accounts. The advantage of the nominee account is the ability to directly participate in the exchange. The risk of market fluctuation of the prices of Newco and T shares between trades is eliminated. Additionally, there may be tax advantages to a direct trade.

The situation concerning brokers who helped U.S. institutional investors move their T shares to offshore nominee accounts raises a couple of separate issues. First, there is a serious question as to whether or not these brokers are independent of the issuer. If P is the sole issuer, then the brokers are likely to be independent, as there is no hint of contact between

²⁷⁰ Interestingly, one of the interviewees was of the opinion that no look through was necessary. Interview with legal counsel for the exchange. He seemed to think that checking an issuer's books, which would usually list a single global certificate, would be sufficient. *Id.* This would result in a single non-U.S. investor. He did not provide any statutory support for this analysis. *See id.* A detailed discussion of look through requirements can be found in Part III(E)(3) of the article.

²⁷¹ Representatives at both of the financial institutions discussed in this article were of the opinion that any securities they purchased on behalf of U.S. retail investors would be held in nominee names. Interviews with F1-1 and F2-1.

²⁷² Rule 12g3-2(a) requires issuers to look through all nominees regardless of geography. This is discussed in Part III(E)(3).

²⁷³ Presumably, investors holding T shares will want to remain invested in the company. If they did not, they would have sold their shares long ago.

the brokers and P. There may have been some contact between T and the brokers. As noted above, T and P are merging and may be treated as one company. In that situation, any T contact with a broker may cause the broker to lose its independence and become effectively a distributor. For Regulation S purposes, distributor is defined as "any underwriter, dealer, or other person who participates, pursuant to a contractual arrangement, in the distribution of the securities offered."²⁷⁴ The contractual arrangement aspect of this definition appears to implicate a question of fact, so the independence of the brokers cannot be resolved definitively in this article. If the brokers are deemed distributors, then moving U.S. shareholders to offshore nominee accounts may be deemed an offer into the United States in violation of Rule 903.²⁷⁵ Of course, to the extent these shareholders are institutional, there is less concern about protecting them.

The second issue raised by the brokers' participation in this deal is that discussed pursuant to the discussion of Section 4(3) of the Securities Act above.²⁷⁶ If Section 4(3) is applicable to transactions under Regulation S, then transactions that occur within forty days of the offering require a Section 4(4) exemption. This requires that the transaction be unsolicited. The factual questions would center on whether or not a referral by T to certain brokers constituted solicitation. The relationship between T and the brokers would have to be examined.

b. *Goals and Effects of Regulation S*

This part examines whether or not Regulation S meets its goals in this context and the effect of Regulation S on the capital markets in the merger context. The goal of Regulation S, as stated above, is to protect U.S. investors and markets, and the method by which it does so is to limit flowback except in cases where there is sufficient information available to U.S. residents.²⁷⁷ The distinction that separates Category 1 from the other categories is the low likelihood of flowback of Category 1 securities. Analysis of this situation suggests that this goal may not have been met entirely with satisfaction. This merger also suggests that Regulation S does little to reduce the efficiency of global capital markets but may disadvantage U.S. markets and investors.

²⁷⁴ Commodity and Securities Exchanges, 17 C.F.R. § 230.902(d) (2002).

²⁷⁵ It is unlikely that these brokers will be deemed to be distributors if institutional investors who purchase from issuers and sell immediately on an exchange are not deemed to be distributors. *See infra* note 239.

²⁷⁶ This was discussed in Part III(B).

²⁷⁷ This concept is developed in Part III(E)(1) of the article.

Category 1 securities are supposed to have a low likelihood of flowback, and few shares are supposed to land in U.S. hands. In this situation, however, the barrier against advertising into the United States may have failed, not because of action by Newco, but because some U.S. investors already owned T stock and were naturally interested in the matter. Indeed, as shareholders, they had a right to be informed about the future of their investment. In this situation, while the newly issued P securities were rightfully classified as Category 1 securities, there were a number of U.S. shareholders that participated in the transaction.²⁷⁸ Therefore, the flowback concern was not adequately met by the conditions of Regulation S.²⁷⁹

The flowback concern in this situation is mitigated by the fact that many of the U.S. investors were institutional investors. Presumably, institutional investors need less protection than individual investors of the general public. Indeed, should the transaction have included a Rule 144A tranche, some of the U.S. shareholders of T may have been able to participate through that mechanism. Therefore, even though the flowback concerns of Regulation S may not have been met, the overall goal of protecting U.S. investors and markets may not have been jeopardized.

The idea that information disclosure will mitigate any damage done by flowback of unregistered securities is inapplicable to this situation. In this context, T, a reporting company, was merged into a non-reporting company, P. Therefore, T, after the merger, stopped filing with the Commission. Newco, however, also does not file with the Commission.²⁸⁰ In this situation, the mitigating effects of disclosure that support the rules behind Category 2 securities do not exist.

From a capital markets perspective, Regulation S seems to have done well in avoiding substantial barriers to capital flow. Most U.S. institutional investors were able to transfer their holdings offshore and participate in the transaction. There would be some transactional costs to this transfer, but there appears to be no reason that such costs would be substantial. Furthermore, individual retail investors could have sold their T holdings in Amsterdam and bought Newco or P stock with the proceeds. Again, there

²⁷⁸ P's new securities were rightly classified as Category 1 securities because P had no trading market in the United States and therefore had no substantial U.S. market interest. Commodity and Securities Exchanges, 17 C.F.R. § 230.902(j) (2002).

²⁷⁹ This supposes that sales to U.S. shareholders through nominee entities are not in violation of Regulation S. If that is not the case, then many of the U.S. shareholders would have been prevented from participating in the transaction, and flowback would have been limited.

²⁸⁰ The only filings Newco has made to the Commission are an annual report, interim financial results, and a couple of circulars to shareholders. Presumably, these were made pursuant to Rule 12g3-2(b)(1)(i). The fact that Newco filed under Rule 12g3-2(b) indicates that the exemption in Rule 12g3-2(a) was not met. Thus, there must be more than 300 U.S. shareholders of Newco.

would be transaction costs. These costs may be slightly more significant because individual investors may have a more difficult time identifying brokers that will trade on foreign exchanges. Alternatively, there appears to be no barrier, except for knowledge, preventing retail investors from undertaking the transaction through nominee entities. The only barrier appears to be U.S. investor knowledge concerning the practice of transferring their New York shares to nominee entities.²⁸¹ Where U.S. residents have an inherent interest in the offering, Regulation S does not pose a significant barrier to U.S. participation, except to the extent that U.S. retail investors do not know about transferring their shares offshore.

From the issuer's perspective, the lack of a U.S. component made little difference. Most of T's U.S. shareholders were able to participate. Furthermore, its prior experience had shown that most of its U.S. shareholders held shares in the form of Amsterdam shares and had bypassed purchasing New York shares. Thus, there was no need for a U.S. component. Regulation S allowed for a smooth transaction bypassing the U.S. markets with little or no loss of access to capital.²⁸² In this way, Regulation S worked smoothly, but the transaction itself calls into question the effectiveness and competitiveness of the U.S. regime.

V. CONCLUSION

This article examined the restrictions, or lack thereof, placed on U.S. retail investors wishing to purchase Category 1 foreign securities. The article, then, through a series of interviews, sought to determine the market's understanding of and response to these regulatory issues. For the most part, market professionals appear to behave according to the dictates of U.S. laws, though sometimes they may not have been aware of the full complications inherent in these laws. One surprising development was the seemingly pervasive use of nominee entities in the transactions studied and the cloud of regulatory ambiguity surrounding such use. Another surprising result was the seeming lack of differentiation by the market between Category 1 and Category 2 securities.

After thorough examination of Regulation S, Section 4(3), and Rule 15a-6, this article concludes that the only potential barriers to U.S. retail

²⁸¹ Presumably, U.S. retail investors holding Amsterdam shares could participate. After all, it appears that U.S. retail investors who invest directly offshore hold their shares under nominee names. See interviews with F1-1 and F2-1; see also *infra* note 271.

²⁸² Indeed, the Newco executive stated that T's experience with ADSs discouraged them from listing again in the United States because registration was costly and those handful of retail investors left holding New York shares merely created problems.

investment in foreign Category 1 securities are those rules that concern advertising and solicitation. In particular, Regulation S imposes prohibitions against directed marketing efforts into the United States on the part of issuers, distributors, and other sellers.²⁸³ If the Section 4(3) forty-day limitation applies to Regulation S distributions, then the non-solicitation provisions concerning Section 4(4) brokers' transactions, delineated in Rule 144(g), must be met when trading within the forty-day restricted period. For unregistered brokers, of course, transactions may not be undertaken on behalf of U.S. residents unless such transactions are unsolicited. These solicitation rules, when met, allow an U.S. investor to purchase Category 1 securities through an established foreign securities exchange or designated offshore securities market.²⁸⁴

The complexity of the brokers' solicitation rules does not appear to have any significant affect on the behavior of the market. As a matter of practice, most U.S. investors will contact a registered broker when interested in a foreign security. These brokers are allowed to advertise their brokerage services and usually do not advertise specific securities unless they are market makers.²⁸⁵ These registered brokers will contact foreign, probably unregistered, brokers and affiliates who are market makers in the foreign security or who are members of the appropriate exchanges to execute the transactions in question. Thus, as a practical matter, the brokers' non-solicitation requirements do not seem to pose any particularly difficult regulatory challenges.

The only serious limitation on U.S. retail investors, then, is the lack of advertising. U.S. investors who do not know about a security will not desire to purchase that security. As a protective barrier for U.S. investors and markets, mere lack of interest seems thin. It does, however, accord with the Commission's pronouncements pertaining to Regulation S.²⁸⁶ Furthermore, since Category 1 securities are issued by foreign companies with no interest in acquiring U.S. investors, this barrier is consistent with the territorial approach to securities regulation.

One surprising inconsistency developed in this article concerns the use of nominee entities when purchasing foreign securities. According to all of

²⁸³ Commodity and Securities Exchanges, 17 C.F.R. § 230.903 (2002); Commodity and Securities Exchanges, 17 C.F.R. § 230.904 (2002).

²⁸⁴ Commodity and Securities Exchanges, 17 C.F.R. § 230.903 (2002); Commodity and Securities Exchanges, 17 C.F.R. § 230.904 (2002).

²⁸⁵ For the most part, registered U.S. brokers would not make markets in foreign securities. One of the financial institutions examined, however, did perform some market-making duties and conduct various "pink-sheet" transactions in select foreign securities, as discussed in Part IV(B) above. In such cases, presumably, the company would have to be careful about to whom it advertised these securities.

²⁸⁶ Offshore Offers and Sales, Exchange Act Release Nos. 33-6863, 34-27942 (Apr. 24, 1990).

those market professionals interviewed, U.S. investors holding foreign securities would most likely hold them through nominee entities. Regulation S does not address nominee entities explicitly, and recent Commission pronouncements treating nominee entities do not provide clear guidelines. All of these Commission statements, however, do indicate that some look through requirement exists to ensure that issuers selling securities under Regulation S determine the residency of beneficial buyers.

From a policy perspective, this requirement makes little sense because Category 1 securities may be sold on an exchange or in a designated market without regard to the identity of a buyer. Of course, the policy arguments are different for Category 2 and Category 3 securities because each of those categories implicates a distribution compliance period. To have two different rules based on the categorization of a security does not represent a problem. The ambiguity presented by nominee entities is an issue ripe for future study, or determination by the Commission, as the market in foreign securities appears to use nominee entities frequently with disregard for the identity of beneficial buyers.

Another area that may require further investigation concerns the distinction between Category 1 and Category 2 securities. This article focused on Category 1 securities under the assumption that Category 2 and Category 3 securities are distinct and separate. From a statutory perspective, that is true. The rules that apply to Category 2 securities are distinctly and substantively different from those that apply to Category 1 securities. From the interviews conducted, however, the distinctions seem to be less pronounced on a practical level. Category 3 securities are always treated differently as they should be. Category 2 securities, however, were infrequently mentioned or considered by those interviewed. Perhaps, because of the small field of interviewees and the focused interview questions, market practices differentiating between Categories 1 and 2 were not elucidated. Regardless of the cause, the present indication is that few distinctions exist, and further study should be conducted on the matter.

The results of this article indicate that U.S. securities laws prevent investment abroad primarily through the prohibition on advertisement and solicitation. The market evidence indicates that the volume of U.S. retail investment abroad is relatively low. While this could be attributed to lack of U.S. interest, it could also indicate that the lack of solicitation and marketing has worked. U.S. residents, unaware of opportunities for foreign investment, do not invest abroad.²⁸⁷ As Internet use becomes increasingly

²⁸⁷ Additionally, foreign opportunities may not look as attractive when compared to U.S. opportunities that are supported by marketing.

global, however, restricting advertisement, and information flows in general, will become increasingly difficult. From the Commission's current perspective, such a development would be unfavorable. For proponents of regulatory competition, however, this development would be generally positive. If advertising flows freely, the analysis of this article shows that U.S. residents can reach foreign markets. Regulatory competition may be achieved without a dramatic rewriting of securities laws. One need only allow the free flow of information.

APPENDIX A

Attached are printouts of two web sites where this author was able to find information on unregistered initial public offerings ("IPOs"). The web sites were found through a couple of searches on Google.com and Yahoo!.com, and the exhibits were printed on April 16, 2002 and May 25, 2002, respectively. Exhibit 1 comes from Yahoo!'s United Kingdom website and displays recent and forthcoming IPOs in the United Kingdom.²⁸⁸ Exhibit 2 is from Credit Suisse First Boston's European web site and lists information on recent European IPOs in which Credit Suisse First Boston is involved.²⁸⁹

Exhibit 1 lists recent and forthcoming IPOs in the United Kingdom. The names of the companies are linked to pages that provide brief information. Presumably, each national Yahoo! page has such a securities page.²⁹⁰

Exhibit 2 is from Credit Suisse First Boston's web site on European IPOs. Before entering this site, there is a disclaimer stating that the web site is not for citizens of the United States.²⁹¹ There were, however, no means of determining whether or not the viewer was a resident of the United States. The names of the issuers listed on this web site are linked to separate pages containing brief descriptions of the issuers and of the securities.

The exhibits follow.

²⁸⁸ To get to an updated version of the exhibited page, go to www.yahoo.com, click on the link at the bottom for the United Kingdom and Ireland. From there, click on Finance, then IPO Centre.

²⁸⁹ An updated version of the web site can be found by going to www.csfb.com/ipo/ and following the link labeled "IPOs@CSFB Europe."

²⁹⁰ Unfortunately, each of the national Yahoo! pages are printed in the nation's native language, and this author does not possess the linguistic proficiency necessary to investigate these other pages.

²⁹¹ This author's experience is that the disclaimer appears only upon the first viewing of the web page by a specific computer. Later visits from the same computer did not generate this disclaimer.

EXHIBIT 1



Home - My Yahoo! -
 Yahoo! - Help

IPO Centre

Financial News | IPO

[Press Speculation](#) | [Flotation Announced](#) | [Prospectus Issued](#) | [Offer Closed](#) | [Recent Floats](#) | [Postponed](#)

Company Name	Trade Begins on:	Market	Description
<u>Investec</u>	29/07/2002	MAIN	Investec is a diverse specialist banking company organised into 4 business units: investment banking, treasury and specialised finance, private client activities and asset management.
<u>HLF Group</u>	16/07/2002	MAIN	HLF was formed in 1999 from the merger of CE Heath and Lambert Fenchurch, in a deal that valued the group at 200m pounds at the time.
<u>Sky Capital Holdings</u>	12/07/2002	AIM	Sky's strategy is to build a financial services group with operations in London and New York. It will provide both share dealing and corporate finance services for SMEs.
<u>Thistle Mining</u>	12/07/2002	AIM	Thistle Mining is a mining finance company, whose primary objective is to establish a substantial gold mining group.
<u>Burberry</u>	12/07/2002	MAIN	Burberry is an international luxury brand owned by GUS, who intend to float off up to 25% of the business.
<u>C&C Group</u>	10/07/2002	MAIN	C&C is Ireland's most broadly based drinks company and is also a leading player in the snack food business and has significant international activities.
<u>St Barbara Mines</u>	08/07/2002	AIM	St Barbara Mines is an Australian gold producer listed on the Australian Stock Exchange.
<u>Music Copyright Solutions</u>	N/A	OFEX	Music Copyright Solutions is a start-up music business, founded by three veterans of the business that have found a gap in the market.
<u>D-etre</u>	N/A	OFEX	D-etre is an investment company concentrating on businesses which utilise the latest technology of the Internet. Their investments propose to cover a wide range of activities encompassing b2b and b2c.
<u>Flying Scotsman</u>	N/A	OFEX	The 78-year-old locomotive plans to become a business, including a fairground and other related products.
<u>Cyworks</u>	N/A	AIM	Cyworks plc was formed in January 2000 to be the holding company of Medical Information Systems Ltd (MIS) and PPF Publications Ltd (PPF), both established publishing and data provision companies.
<u>Applied Technology Monitoring</u>	N/A	OFEX	Applied Technology Monitoring makes web-enabled video monitoring system.

EXHIBIT 2

CS GROUP

Marketing (Pre-Bookbuilding)

Books Open	Issuer	Industry	Country	Exchange	Deal Size	ADR Avail	GDR Avail	Price	Deal Type
25-Apr-2002	Alfa Laval AB	Construction & Engineering	SWEDEN	STKSE	SEK 8,000 M	No	No	TBD	IPO
24-Apr-2002	HMV Group	General Merchandise Stores	UNITED KINGDOM	LSE	TBD	No	No	TBD	IPO

Recently Priced Transactions

Pricing Date	Issuer	Industry	Country	Exchange	Deal Size	ADR Avail	GDR Avail	Price	Deal Type
3-Apr-2002	Novartis	Pharmaceuticals	SWITZERLAND	ZRH	CHF 1,479 M	No	No	64.3	Block Trade
17-Mar-2002	Petrol Ofisi AS	Oil & Gas Refining & Marketing	TURKEY	ISSE	TRL 225,000,000 M	No	No	TRL 30,000	Secondary
13-Mar-2002	Micronas	Semiconductors	SWITZERLAND	FSE/ ZSE	CHF 187 M	No	No	CHF 31	Secondary
7-Mar-2002	Arcelor	Steel	LUXEMBOURG	BRUSE/ LUXSE/ MADSE/ PARSE	EUR 150.6 M	No	No	EUR 14.25	Secondary
21-Feb-2002	Yukos	Integrated Oil & Gas	RUSSIA	RTS	USD 144 M	No	Yes	USD 98.25	Accelerated Bookbuild
10-Dec-2001	STMicroelectronics NV	Semiconductors	NETHERLANDS	PARSE	EUR 2,400 M	No	No	EUR 35.75	Secondary
6-Dec-2001	Koninklijke KPN NV	Integrated Telecommunication Services	NETHERLANDS	AMSE	EUR 5,000 M	Yes	No	EUR 4.9	Secondary
2-Dec-2001	Snam Rete Gas	Oil & Gas Refining & Marketing	ITALY	MILSE	EUR 2,202 M	No	No	EUR 2.8	IPO
28-Nov-2001	Helvetia Patria	Multi line Insurance	SWITZERLAND	ZRH	TBD	No	No	CHF 255	Secondary
20-Nov-2001	Thales S.A.	Electronic Equipment & Instruments	FRANCE	DTB/ LSE/ PARSE	EUR 275 M	No	No	EUR 38.85	Secondary
15-Nov-2001	Swiss Reinsurance Co.	Reinsurance	SWITZERLAND	ZRH	CHF 1,885 M	No	No	CHF 185.75	Secondary
2-Nov-2001	Easyjet plc	Airlines	UNITED KINGDOM	LSE	GBP 146 M	No	No	GBP 3.75	Secondary
17-Oct-2001	Electronics Boutique PLC	Computer & Electronics Retail	UNITED KINGDOM	LSE	GBP 68 M	No	No	GBP 1	Accelerated Bookbuild
24-Jul-2001	Galen Holdings	Pharmaceuticals	UNITED KINGDOM	DUBSE/ LSE/ NASD	GBP 258 M	Yes	No	GBP 7.55	Secondary
20-Jun-2001	Leica Geosystems	Electrical Components & Equipment	SWITZERLAND	SWX	CHF 51.9 M	No	No	CHF 470	Accelerated Bookbuild
19-Jun-2001	Alstom S.A.	Heavy Electrical Equipment	FRANCE	PARSE	EUR 390.4 M	No	No	EUR 32	Accelerated Bookbuild

