

RECENT DEVELOPMENTS

SECURITIES REGULATION—GREAT EXPECTATIONS AND THE REALITY OF RULE 144A AND REGULATION S; THE SEC'S APPROACH TO THE INTERNATIONALIZATION OF THE FINANCIAL MARKETPLACE

Recently, the Securities and Exchange Commission (the "SEC") enacted new rules, Regulation S and Rule 144A, which clarify the SEC's position on the extraterritorial application of United States securities laws and establish an officially sanctioned procedure to be used in the offering and resale of privately placed securities to qualified buyers. The SEC also approved PORTAL, a new automated system designed to facilitate trading in securities issued under Rule 144A.

I. LEGAL BACKGROUND

The federal Securities Act of 1933¹ (the "1933 Act" or the "Securities Act") prohibits the sale of any securities unless its issuer satisfies certain registration requirements. Section 5 of the 1933 Act² mandates that one who offers or sells securities comply with the SEC's registration provisions³ unless a valid exemption⁴ from registration is available. Registration is intended to furnish prospective investors with prescribed financial information about the company issuing the securities in order to provide the investors with a sound basis for making an investment

¹ 15 U.S.C. §§ 77a-77aa (1988).

² 15 U.S.C. § 77e.

³ A great deal of information about the issuer and the security must be disclosed; for a schedule of information required in a registration statement, see 15 U.S.C. § 77aa.

⁴ Generally, §3 (15 U.S.C. §77c) of the Securities Act provides exemptions for certain securities, including securities of public authorities and banks (§3(a)(2)), short-term notes (§3(a)(3)), securities of nonprofit issuers (§3(a)(4)), building and loan securities (§3(a)(5)), railroad equipment trusts and certificates of deposit (§3(a)(6)), receivers and trustees certificates (§3(a)(7)), and insurance policies and annuities (§3(a)(8)). Further, the Securities Act exempts particular types of transactions, including voluntary exchanges (§3(a)(9)), judicially or administratively approved exchanges (§3(a)(10)), intrastate issues (§3(a)(11)), small issues (§3(b), 3(c), 4(6)), and certain limited offerings. For a comprehensive discussion of available exemptions from the registration requirements of the Securities Act, see LOSS & SELIGMAN, SECURITIES REGULATION 1142-1471 (1989).

decision. Section 5 requires that a registration statement, which includes a disclosure document called a "prospectus," be filed with the SEC. Foreign companies traditionally avoided issuing securities in the United States public capital market because of the time and expense involved in complying with federal registration and disclosure requirements.⁵

Although section 5 of the 1933 Act seems to apply to virtually any sale of securities,⁶ a transaction deemed to be a "private offering" is exempt from registration under section 4(2) of the 1933 Act.⁷ The concept of a "private offering," while not defined in the 1933 Act, has been developed by the courts and the SEC. In *SEC v. Ralston Purina*,⁸ the Supreme Court determined that because exempt transactions are those for which "there is no practical need" for the application of the 1933 Act's registration requirements, the availability of an exemption under section 4(2) depends upon "whether the particular class of persons affected needs the protection of the [1933] Act."⁹ According to the *Ralston Purina* Court, an offering to investors able to "fend for themselves" is to be considered a transaction "not involving any public offering."¹⁰

Transactions involving investors able to "fend for themselves" are commonly called "private placements."¹¹ Investors in the private place-

⁵ "[The United States] has the most rigorous disclosure system in the world," according to former SEC chairman David Ruder. *Lawmakers Set Agenda Amid Growing Worry that U.S. has Lost Edge in Global Capital Markets*, 2 INT'L SEC. REG. REP. 9 (1990).

⁶ Section 5(a) stipulates that "unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly — (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise." 15 U.S.C. § 77(e).

⁷ Section 4(2) indicates that "[t]he provisions of section 5 [15 U.S.C. § 77e] shall not apply to transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(2).

⁸ *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119 (1953). The SEC referred to this case as "the seminal Supreme Court construction of Section 4(2) of the Securities Act" in their release proposing Rule 144A. Securities Act Release No. 33-6806 (Oct. 25, 1988), 53 FED. REG. 44016, 44024 (1988).

⁹ 346 U.S. at 125.

¹⁰ *Id.* After *Ralston Purina*, the lower courts made efforts to "focus . . . on the need of the offerees for the protection afforded by registration." Securities Act Release No. 33-6806 (Oct. 25, 1988), 53 FED. REG. 44016, 44024 (1988), citing *Ralston Purina*, 346 U.S. at 127.

¹¹ The private placement market has boomed over the past decade. In 1980, issuers released \$16 billion in privately placed securities. This figure rose to over \$170 billion in 1989. *Shaking Up America's Capital Markets*, THE ECONOMIST, Apr. 21, 1990, at 89, 90.

ment market almost exclusively are institutions,¹² including insurance companies, private pension funds, state and local retirement funds, state and local governments, trust accounts managed by banks, certain foreign institutions, and venture capitalists.¹³ Such institutions are thought to be powerful and sophisticated enough to be able to insist upon appropriate disclosure as a condition to committing their funds, therefore not in need of the protection of the 1933 Act's registration and disclosure provisions.¹⁴

The private placement market appeals to larger capital-seeking companies for several reasons. First, private placements are exempt from the detailed disclosure mandated by the SEC for public issues. Second, a private issue may incur less than one-third of the costs generated by investment banks, lawyers, and rating agencies involved in a public issue.¹⁵ Third, a private placement can be put together in days or weeks, while registration of a public issue with the SEC may take months.¹⁶ Yet in the past, the United States private capital market usually was not the first choice of a foreign issuer seeking funds; illiquidity, due to restrictions¹⁷ on the resale of privately placed securities, tended to increase the cost of capital, thus prompting foreign issuers to resort either to their domestic market or to the Euromarkets to meet their capital needs.

¹² An important case regarding institutional investors' ability to "fend for themselves" is *The Value Line Fund, Inc. v. Marcus*, 161 F. Supp. 533 (S.D.N.Y. 1958). *Value Line* concerned a mutual fund's purchase of unregistered stock from an issuer who had offered the stock to several other mutual funds; when the stock price fell, the mutual fund alleged violations of §5 and sued for rescission. The court ruled against the mutual fund, determining that the offering was private because all of the offerees were "sophisticated, knowledgeable, experienced institutional investors with great resources, and plainly were 'able to fend for themselves.'" *Value Line*, 161 F. Supp. at 537.

¹³ Securities Act Release No. 33-6806 (Oct. 25, 1988), 53 Fed. Reg. 44016, 44020 (1988).

¹⁴ For a discussion of the development of the private placement market and the growing dominance of the institutional investor, see Note, *Capital Markets in Transition: A Response to New SEC Rule 144A*, 66 IND. L. J. 233 (1990) [hereinafter Note].

¹⁵ Printing, agency, legal and underwriting costs could easily amount to over \$500,000 for a \$25 million public issue. *Id.*

¹⁶ *Id.*

¹⁷ Generally, securities not registered with the SEC are "restricted" and cannot be freely sold to the public. Failure to comply with federally imposed restrictions on the resale of securities may result in SEC sanctions and/or a private action for damages by the purchaser of the securities under §12(1) of the 1933 Act. 15 U.S.C. § 77(1).

The SEC recently embraced measures which could make the United States capital market more appealing to foreign investors and boost the competitiveness of the United States securities market internationally. On 19 April 1990, the SEC adopted Rule 144A,¹⁸ which sanctions and clarifies the proper procedure for the primary placement and resale of unregistered securities to certain institutional investors. In adopting Rule 144A, the SEC recognized at least two trends transforming United States capital markets: the increasing role that institutional investors play in the United States securities market, and the private placement market's challenge to the public market's share of total corporate financings.¹⁹ Many observers thought that Rule 144A would enhance the liquidity and efficiency of the private placement market, thus stimulating further growth of the private market. Arguably, however, the primary purpose of the SEC in adopting 144A was to enhance the United States securities market's competitiveness internationally by making the United States market more attractive to foreign issuers.²⁰

That same day, the SEC also approved PORTAL,²¹ an electronic system on which securities privately placed under Rule 144A can be traded. The SEC hoped that PORTAL would facilitate the trading of Rule 144A securities. Prior to the development of the PORTAL system, the resale market in unregistered securities was essentially a traditional over-the-counter market, in which issuer and investor conducted negotiations without the benefit of a quotation dissemination system or automated trade comparison system. The SEC believed that PORTAL would provide such benefits, thus enhancing the efficiency of the 144A market's operation.

Concurrently with the adoption of Rule 144A and the approval of PORTAL, the SEC promulgated Regulation S,²² which clarifies the extraterritorial application of the registration requirements of the 1933

¹⁸ 17 C.F.R. § 230.144A (1990), Securities Act Release No. 33-6862 (Apr. 23, 1990), 55 FED. REG. 17933 (1990).

¹⁹ Note, *supra* note 14.

²⁰ The Bureau of National Affairs called the SEC's initial proposal of Rule 144A a "long-awaited step viewed by many as encouraging foreign issuers to use the [U.S.] domestic market for capital-raising purposes." *SEC Issues Proposed Rule 144A, Would Ease Resales to Institutions*, 20 SEC. REG. & L. REP. (BNA), No. 43, at 1668 (Nov. 4, 1990).

²¹ Exchange Act Release No. 33-27956 (Apr. 27, 1990), 55 FED. REG. 18781 (1990). PORTAL stands for Private Offerings, Resales, and Trading through Automated Linkages.

²² Offshore Offers and Sales, 17 C.F.R. 230.901-904 (1990), Securities Act Release No. 33-6836 (April 24, 1990), 55 FED. REG. 18306 (1990).

Act.²³ In promulgating Regulation S, the SEC eschewed an application of federal securities laws based upon citizenship in favor of an application based upon territoriality. Prior to Regulation S, it was widely held that "United States citizens, like citizens of the Roman Empire, carried the United States securities laws wherever they went."²⁴ If the guidelines set forth in Regulation S are satisfied, however, all offers, sales, and resales occurring outside of the United States are not subject to section 5 of the 1933 Act.²⁵ The adoption of Regulation S suggests a new approach to SEC regulation, one which focuses protective efforts on the United States securities market rather than United States citizens.

The SEC implemented these controversial changes in response to an internationalization of the financial marketplace.²⁶ By eliminating the need to comply with burdensome registration requirements for securities issued under Rule 144A, the SEC hoped to attract foreign issuers to the United States capital market. Furthermore, in Regulation S the SEC eliminated existing uncertainty regarding the extraterritorial application of United States securities laws, exempting all offers, sales, and resales made outside of the United States from the registration requirements of the Securities Act. Many proclaimed these rule changes to be revolutionary;²⁷ the market, however, has been slow to respond.

²³ Regulation S clarifies longstanding views of the SEC regarding securities transactions which take place abroad, providing guidelines for offshore transactions to ensure that they are not subject to registration requirements. Investors and issuers previously relied on Release 4708 (Securities Act Release No. 33-4708 (July 9, 1964), 29 Fed. Reg. 9828 (1964)) and SEC "no-action letters" issued pursuant to the release in structuring offshore transactions. In Release 4708, the SEC indicated that it would take no action regarding a United States corporation's failure to register securities to be distributed solely to foreign nationals abroad if the distribution was effected in a manner that would result in the securities "coming to rest abroad."

²⁴ Greene, *Reproposed SEC Rule 144A*, 21 INST. ON SEC. REG. 4 (1990) (Edward F. Greene is a commissioner on the SEC).

²⁵ According to the SEC,

[p]rinciples of comity and the reasonable expectations of participants in the global markets justify reliance on laws applicable in jurisdictions outside the United States to define requirements for transactions effected offshore. The territorial approach recognizes the primacy of the laws in which a market is located. As investors choose their markets, they choose the laws and regulations applicable in such markets.

Securities Act Release No. 33-6863 (April 24, 1990), 55 FED. REG. 18306 (1990).

²⁶ Richard C. Breeden, current chairman of the SEC, proclaimed April 20 (the day on which both Regulation S and Rule 144A were adopted) to be "a historic day for the commission and its international program." Wayne, *SEC Authorizes a Freer Market for Big Investors*, N.Y. Times, Apr. 20, 1990, § A, at 1, col. 2.

²⁷ In the early 1980s, the London Stock Exchange (LSE) was having difficulty competing in the international securities markets. In an attempt to maintain London's

II. NEW LAW

A. Rule 144A

A Rule 144A transaction is subject to three basic conditions: first, the securities must not be of the same class as those listed on a United States securities exchange or quoted in the National Association of Securities Dealers Automated Quotation system (NASDAQ);²⁸ second, the sale must be made to a qualified institutional buyer (QIB)²⁹ who is aware of the seller's reliance upon the Rule 144A exemption;³⁰ third, the seller and the prospective purchaser may request basic financial information from the issuer of the securities.³¹ Of these three conditions, perhaps the most troublesome is the information requirement.

Rule 144A's information requirement reflects the 1933 Act's concern that a prospective buyer have enough information about the issuer to make an informed investment decision. To satisfy the information requirement, Rule 144A requires the issuer to make available upon request a brief description of its business and financial statements from any part of the preceding two fiscal years during which the issuer has been in operation.³² Yet if an issuer is a reporting company under the

position as a major international financial center, the LSE (now known as the International Stock Exchange) experienced a dramatic deregulation which became known as the "Big Bang." The changes in the United Kingdom put pressure upon the stock markets of continental Europe to improve their regulatory systems. For a complete discussion, see POSER, *INTERNATIONAL SECURITIES REGULATION; LONDON'S "BIG BANG" AND THE EUROPEAN SECURITIES MARKETS* (1991).

²⁸ 17 C.F.R. 230.144A(d)(3)(i). This requirement ensures that securities issued under Rule 144A will not be fungible with securities listed on United States exchanges.

²⁹ A "qualified institutional buyer" must in the aggregate own and invest on a discretionary basis at least \$100 million in securities of issuers not affiliated with that QIB. Banks and savings and loan institutions (both United States and foreign), in addition to meeting the \$100 million requirement, must have a net worth of at least \$25 million to be deemed QIBs. Broker-dealers that are registered under the Securities Exchange Act of 1934 (the "Exchange Act") need only meet an eligibility threshold of \$10 million. 17 C.F.R. 230.144A(a). In defining a QIB, the SEC established a level of minimum holdings which attempts to ensure that participating investors have extensive experience in the private resale market for restricted securities, thus in little need of the protection of the 1933 Act. Securities Act Release No. 33-6806 (Oct. 25, 1985) 53 FED. REG. 44016, 44028 (1988).

³⁰ "Although the Rule imposes no resale restrictions, a seller or any person acting on its behalf must take reasonable steps to ensure that the buyer is aware that the seller may rely on the exemption from the Securities Act's registration requirements afforded by Rule 144A." Securities Act Release No. 33-6862 (Apr. 23, 1990), 55 FED. REG. 17933, 17934 (1990).

³¹ 17 C.F.R. 230.144A(d)(4)(i).

³² *Id.*

Securities Exchange Act³³ (the "Exchange Act"), a holder wishing to resell securities under Rule 144A has no duty to provide the prospective purchaser with any information about the issuer.³⁴ Additionally, foreign issuers may file information which they would normally file on their domestic exchange to gain exemption from Rule 144A's information requirement.³⁵

B. PORTAL

PORTAL is a new trading system designed by the National Association of Securities Dealers, Inc. (NASD) to encourage secondary trading of 144A securities. The PORTAL system will also provide facilities for primary placements of Rule 144A securities. The PORTAL market is comprised of computer and communication facilities which, in addition to supporting primary placements and resale trading, will provide for the clearance and settlement of domestic and foreign debt and equity securities through designated PORTAL clearing and depository organizations.³⁶

C. Regulation S

Regulation S³⁷ contains a general statement of applicability which provides that while any offer or sale that occurs within the United States³⁸ is subject to the registration requirements of section 5 of the Securities Act,³⁹ any offer or sale that occurs outside the United States

³³ 15 U.S.C. §§ 78a-78kk (1988).

³⁴ 17 C.F.R. 240.144A(d)(4)(i).

³⁵ Under the Exchange Act, foreign companies listed on United States exchanges must file an annual form with the SEC; while not as comprehensive as the filing required of domestic companies, it is still a substantial document including a reconciliation of earnings and equity between the domestic Generally Accepted Accounting Principles (GAAP) of the foreign company and United States GAAP. The preparation of such a filing is expensive both in terms of management time and consultants' fees. *Rule 144A Placements*, WORLD ACCOUNTING REPORT, Nov. 1990 at 121. Yet Rule 12g3-2(b) relieves foreign issuers from the Exchange Act's reporting requirements if they make publicly available in the United States the information which they are required to make available in their home countries. 17 C.F.R. 240.12g3-2(b). Rule 144A stipulates that foreign issuers exempt from the reporting requirements of the Exchange Act pursuant to Rule 12g3-2(b) need not comply with its information requirement; in this manner Rule 144A attempts to create a market in which foreign companies submit not United States GAAP computations but information which they would normally file on their domestic exchange.

³⁶ Release No. 33-27956, *supra* note 21.

³⁷ See *supra* note 22.

³⁸ "United States" means the United States of America, its territories and possessions, any State of the U.S., and the District of Columbia. 17 C.F.R. 230.902(p).

³⁹ 15 U.S.C. § 77e.

is not subject to section 5. Regulation S creates two non-exclusive⁴⁰ "safe harbors," one of which applies to issuers while the other applies to resales, which ensure that transactions completed according to the guidelines set forth therein will be deemed to have taken place outside of the United States and, therefore, not subject to the registration requirements of section 5.

Two general conditions apply to these safe harbors. First, any offer, sale, or resale must be made in an "offshore transaction."⁴¹ Second, no "directed selling efforts"⁴² may be made in the United States in connection with an offer or sale made under a safe harbor. Furthermore, the safe harbor applying to issuers distinguishes between three categories of securities offerings, based upon factors such as nationality, reporting status of the issuer, and the degree of United States market interest in the issuer's securities.⁴³ The issuer safe harbor requires the implementation of certain safeguards, which vary for each of the three categories, to ensure that the securities offered do not flow back into the United States.⁴⁴ Any offer, sale, or resale made in compliance with the applicable safe harbor is deemed to be outside of the United States, thus not subject to the registration requirements of section 5.⁴⁵

⁴⁰ "Attempted compliance with any Rule in Regulation S does not act as an exclusive election; a person making an offer or sale of securities may also claim the availability of any applicable exemption from the registration requirements of the [1933] Act." Preliminary Note 8 to Regulation S, *supra* note 23.

⁴¹ An offshore transaction requires that no offers be made to persons in the United States and that either: (i) the buyer is (or the seller reasonably believes that the buyer is) offshore at the time of the origination of the buy order, or (ii) for purposes of the issuer safe harbor, the sale is made in, on or through the facilities of a designated offshore securities market. 17 C.F.R. 230.902(b).

⁴² "Directed selling efforts" are activities undertaken for the purpose of, or that could reasonably be expected to result in, conditioning the market in the United States for the securities being offered. 17 C.F.R. 230.903.

⁴³ The first category includes securities offered in "overseas directed offerings" (see 17 C.F.R. 230.902(j)), securities of foreign issuers in which there is no substantial United States market interest, securities backed by the full faith and credit of a foreign government, and securities issued pursuant to certain employment benefit plans. The second category includes offerings of securities of United States reporting issuers and offerings of debt securities, asset-backed securities and specified preferred stock of foreign issuers with a substantial United States market interest. The third, residual category includes all securities not contained within the previous categories. 17 C.F.R. 230.903.

⁴⁴ Offerings under the first category may be made without any restrictions beyond the general conditions. Offerings falling under the other two categories are subject to additional safeguards, such as restrictions on offers and sales to or for the benefit of United States persons. See 17 C.F.R. 230.903.

⁴⁵ Securities Act Release No. 33-6863 (April 24, 1990), 55 FED. REG. 18306, 18309 (1990).

III. ANALYSIS

A. *Criticism of the New Rules*

In their 1988 releases proposing Rule 144A and Regulation S,⁴⁶ the SEC solicited comments from the financial community. As a result of this input, Rule 144A and Regulation S experienced several transformations before their final adoption.⁴⁷ Yet criticism, particularly of Rule 144A, remains despite revision of the original proposals.

The investment banking community has criticized Rule 144A's information requirement as introducing an "inappropriate inefficiency" to the resale of Rule 144A securities.⁴⁸ In the release adopting Rule 144A, one SEC commissioner wrote a separate statement in which he objected to the information requirement, claiming its inclusion "contradicts the justification" of the rule.⁴⁹ Yet proponents assert that compliance with the information requirement for Rule 144A securities may not be as burdensome as supplying the information required of publicly offered securities, for disclosure will be "market-driven;" the buyer, not the SEC, determines what information must be disclosed.⁵⁰

⁴⁶ The SEC proposed Regulation S in Securities Act Release No. 6779 (June 10, 1988), 53 Fed. Reg. 22661 (1988). Rule 144A was proposed in Securities Act Release No. 33-6806 (Oct. 25, 1988), 53 Fed. Reg. 44016 (1988).

⁴⁷ After receiving 95 comment letters on the initial proposal, the SEC repropoed Regulation S in Securities Act Release No. 33-6838 (July 11, 1989), 54 Fed. Reg. 30063 (1989). After 44 additional letters, Regulation S was adopted in its final form. Securities Act Release No. 33-6863 (April 24, 1990), 55 Fed. Reg. 18306, 18307 (1990). After 89 comment letters, Rule 144A was repropoed in Securities Act Release No. 33-6839 (July 10, 1989), 54 Fed. Reg. 30076 (1989). After 54 letters responding to the reproposal, Rule 144A was adopted in its final form. Securities Act Release No. 33-6862 (April 23, 1990), 55 Fed. Reg. 17933 (1990).

⁴⁸ Bloomenthal, *PORTAL—A NASDAQ For Restricted Securities*, 12 SEC. & FED. L. REP. 89, 93 (1990). For a critical discussion of the information requirement, "probably the most controversial aspect of the rule as adopted," see McLaughlin, *Foreign Issues and Rule 144A*, N.Y.L.J., Oct. 25, 1990 at 5.

⁴⁹ Commissioner Fleischman contended that "[t]o distrust the ability of these major institutions to make [a determination of what information is necessary for decisionmaking], and to mandate the provision of individual-investor-type information in order to protect these institutions from their Commission [SEC] perceived frailty in the face of an informationless sales pitch, is to shred the very justification for the Rule." Securities Act Release No. 33-6862 (April 23, 1990), 55 Fed. Reg. 17933, 17947 (1990).

⁵⁰ Stern, *Private but Public*, FORBES, March 5, 1990, at 48. One banking executive asserts that "[t]he SEC is betting that the market has reached a level of sophistication such that self-regulation is better than government regulation." Brady, *Evolution, Not Revolution*, EUROMONEY, June 1990, at 47. Another commentator asserts, however, that due to informational demands of issuers and investment banks' liability

The information requirement might also be necessary to stimulate the interest of United States investors, who may be reluctant to invest in companies with which they are not familiar and about which they know little.⁵¹

Additionally, the qualifications imposed upon institutional buyers who wish to participate in the 144A market have come under fire. Market observers have criticized the definition of the QIB, asserting that the ceilings may be too high, thus excluding too many sophisticated buyers.⁵² Banks also have criticized the Rule 144A tests which determine whether a bank can qualify as a QIB, claiming that the tests are overly restrictive and put banks at a disadvantage. First, banks may not count all securities for the purposes of meeting the \$100 million threshold.⁵³ Banks claim to be further disadvantaged by the additional requirement that they have an audited net worth of at least \$25 million.⁵⁴ Yet the SEC gave the banks the additional requirement "[b]ecause of the unique status of such financial institutions as federally-insured depository institutions;"⁵⁵ the net-worth requirement appears to be not a better measure of sophistication but a means to ensure that the banks do

concerns, "the vast majority of large private placements through established investment banks are associated with no less disclosure of information, and no less investigative diligence on the part of those investment banks" than public offerings of comparable size. Cooper, *Misperceptions of a Move of Globalization*, PENSIONS & INVESTMENT AGE, Oct. 29, 1990, at 16, 17.

⁵¹ Hargraves, *Revolution in the Air for U.S. Securities Traders*, Fin. Times, Apr. 11, 1990, at 32.

⁵² "By limiting the universe of institutional buyers eligible to participate in the Rule 144A market to those with \$100 million or more invested in securities, the SEC might well have precluded achievement of the minimum critical mass necessary to attract buyers normally accustomed to the public marketplace." Cooper, *supra* note 50, at 17.

⁵³ Those disallowed include United States government securities, bank deposit notes and certificates of deposit, loan participations, repurchase agreements, and currency-interest rate and commodity swaps, which constitute a significant portion of most banks' invested capital. *Banks Critical of QIB Rules*, 3 INT'L SEC. REG. REP. 14, 4 (1990).

⁵⁴ 17 C.F.R. 230.144A(a)(vi).

⁵⁵ "As federally-insured depository institutions, domestic banks and savings and loans are able to purchase securities with funds representing deposits of their customers. These deposits are backed by federal insurance funds administered by the Federal Deposit Insurance Corporation. In light of this government support, these financial institutions are able to purchase securities without placing themselves at risk to the same extent as other institutions. In this respect, banks effectively are able to purchase securities using public funds. Therefore, the amount of securities owned by a bank or savings and loan institution may not, on its own, be a sufficient measure of such institution's size and investment sophistication" 55 FED. REG. 17933, 17956.

not take risks with funds which are not theirs. The SEC has called for further comment on the appropriateness of the net worth test, as well as the \$25 million threshold, and may modify these requirements in the future.

One commentator asserts that foreign issuers have been hesitant to test the Rule 144A waters because of the rule's murkiness regarding issuer liability for resales not made in compliance with Rule 144A or another exemption from registration.⁵⁶ Rule 144A contains ambiguous guidance regarding an issuer's responsibility for subsequent resales by investors.⁵⁷ Due to this liability risk, issuers are unwilling to abandon traditional protective covenants derived through the process of negotiation; thus, transaction costs stay high and securities remain relatively illiquid. However, having previously shown a willingness to amend the rules in response to the concerns of market participants, the SEC can clarify issuer liability rules.

One commentator, while acknowledging that the SEC intended the rule changes to facilitate and increase trading of foreign securities by large United States institutional investors, criticizes Rule 144A for failing to "address the interests of individual investors and small institutions in buying foreign equities" and for failing to "encourage foreign issuers to enter a regulated market where investor protection is given a high priority."⁵⁸ Her first contention neglects to acknowledge that foreign issuers must be enticed to enter what traditionally has been a highly regulated United States market. The SEC chose to attract foreign issuers by relaxing the registration requirements for certain investors who are deemed able to fend for themselves. In the SEC's opinion, sophisticated institutional investors are most able to handle such transactions without SEC-mandated registration information. As

⁵⁶ McLaughlin, *An Issuer's Obligation is Unclear; SEC Rule 144A*, NAT'L LAW J., Nov. 5, 1990, at 16.

⁵⁷ *Id.*

⁵⁸ Karmel, *New Rules for Trading Foreign Securities*, N.Y.L.J., June 28, 1990, at 3, col. 1.

The technical and convoluted nature of the newly adopted rules . . . suggests what is wrong with them. Rather than directly confronting the internationalization of the markets and the differing disclosure standards of the major securities markets, the SEC has carved out intricate exemptions for the trading of foreign securities by large institutions. With the assistance of a sophisticated securities lawyer, such investors may be able to buy and resell foreign securities more readily than before. However, the benefits of such deregulation are not available to other investors.

Id. at 6, col. 5.

for the second contention, Rule 144A's information requirement attempts to reduce the burden of registration and disclosure, which should attract foreign issuers. Furthermore, PORTAL attempts to make the 144A market more appealing by creating an automated system for the primary placement and resale of Rule 144A securities.

The financial marketplace has been slow to embrace the PORTAL system. This tepid reception is attributable in part to the overall decline in private placements since the system has been in operation.⁵⁹ Additionally, investors may be reluctant to forego the opportunity to negotiate favorable terms with the issuer merely to utilize an automated system.⁶⁰ In response, the NASD plans to convert PORTAL from a closed system with narrow participation to an open trading and information system.⁶¹ Yet PORTAL continues to have potential;⁶² in December 1990, PORTAL listed new securities placed by British electric utility companies valued at \$600 million, the largest issue yet under Rule 144A.⁶³ Apparently, many institutions sought the shares but did not know where to obtain them.⁶⁴ As issuers and investors become more familiar with PORTAL, perhaps the system will play a more important role in the Rule 144A market.

The SEC should continue its efforts to improve upon the new rules. Rule 144A, because it essentially creates a new market, deserves special attention. Indeed, the SEC has stated that Rule 144A represents only "the first step toward achieving a more liquid and efficient institutional resale market for unregistered securities;" the SEC "intends to monitor the evolution of this market" and make changes they deem to be

⁵⁹ See note 81, *infra*.

⁶⁰ Negotiated deals are a significant part of the advantage private placements present to issuers and investors. Gillen, *NASD System for Private Placement Draws Yawns from Market*, BOND BUYER, Dec. 14, 1990, at 3.

⁶¹ "Three current restraints will be removed: prequalification by NASD of institutional buyers; segregated accounts for PORTAL securities; and settlement of transactions solely through the PORTAL depository and clearance system." Corrigan, *International Equity Issues: NASD Proposes Changes to PORTAL*, FIN. TIMES, Feb. 6, 1991, at 32.

⁶² The American Stock Exchange and Reuters currently are engaged in a joint venture to develop a rival system called SITUS which will offer information and automatic trading execution. *The Public World of Private Placements*, THE ECONOMIST, Sept. 22, 1990, at 86. The New York Stock Exchange also plans to establish a system for trading 144A securities. *NYSE Proposes Creation of New System for Buying, Selling Rule 144A Stocks*, Bureau of Nat'l Affairs' Daily Report for Executives, (Sept. 14, 1990) at A-2.

⁶³ Norris, *Market Place: Some Fast Profits in British Utilities*, N.Y. Times, Dec. 12, 1990, at D6, col. 3.

⁶⁴ *Id.*

“appropriate.”⁶⁵ The SEC must continue to adhere to this responsive approach to regulatory liberalization if Rule 144A is to fulfill its potential.

B. Great Expectations

Rule 144A was hailed as a major innovation which would revolutionize the market for privately placed securities. The SEC, in the release proposing Rule 144A, proclaimed that the new rule could increase the efficiency of the private placement market, enhance the liquidity of securities in this market, and contribute to the further growth of the private market.⁶⁶ Most importantly, however, the SEC hoped Rule 144A and Regulation S would encourage foreign involvement in the United States market.

Rule 144A and Regulation S have the potential to boost the efficiency of the United States private placement market. Many thought that the clarification of registration requirements would make the market more efficient. Some hoped that private placement documentation would become “streamlined” as issuers and investors developed standard covenants to use in private offerings.⁶⁷ PORTAL supposedly added to this efficiency by providing a system through which eligible dealers and investors could get information about primary offerings and sec-

⁶⁵ Securities Act Release No. 33-6862 (Apr. 23, 1990), 55 FED. REG. at 17933, 17934 (1990). Among the issues that the SEC expects to consider are “the nature and number of regular participants in the market, the types of securities traded, the liquidity of the market, the extent of foreign issuer participation in the private market, the effect of the Rule 144A market on the public market, and any perceived abuses” of the rule. *Id.*

⁶⁶ Proposed Rule 144A could have a significant impact on both primary and secondary domestic markets for unregistered securities of reporting as well as nonreporting issuers. Removing uncertainties as to the legitimacy of resales to institutional buyers by providing a safe harbor from registration could permit some transactions to take place that otherwise might not occur. Such transactions might include resales by persons that purchased securities privately with a view to their immediate resale to a number of institutions. Providing a framework in which institutional resales could be made freely may increase the efficiency of the private placement market. Liquidity in the market may increase, not only as the result of increased efficiency, but also as a consequence of the resale provisions of proposed Regulation S. The potential increase in efficiency and liquidity could significantly lower the discount commonly associated with private placements, which in turn may attract an increasing number of issuers to the private placement market. Securities Act Release No. 33-6806 (Oct. 25, 1988), 53 FED. REG. 44016, 44022 (1988).

⁶⁷ Glover, *Good Intentions in a Bad Economy*, Legal Times, Dec. 31, 1990, at 20.

ondary resales displayed on computer screens and settle resulting trades through a central depository.

Another benefit anticipated from the adoption of Rule 144A was an increase in the liquidity of the securities in the private placement market. Ordinarily, unregistered securities are "restricted" and cannot be freely resold.⁶⁸ Under Rule 144A, however, resales between QIBs can occur immediately after issue. Thus the creation of a separate trading market for privately placed securities theoretically eliminates the illiquidity previously resulting from restrictions on their resale.⁶⁹

Rule 144A also was expected to enhance the appeal of the private market to issuers. Observers expected Rule 144A to lower the cost of capital to issuers, who traditionally had to offer higher yields to investors to compensate for the illiquidity of unregistered issues; many thought this lower cost of capital would attract more issuers to the private market. Experts predicted that the entry of new investors and issuers into the private market would reduce the price spread between the private and public markets.⁷⁰ Some even suggested that the private market would draw so much capital from the public markets that the SEC would have to relax the restrictive requirements governing public deals.⁷¹ One commentator asserted that Rule 144A, by lowering illiquidity premiums and transaction costs, "is certain to increase the demand for private placements."

Arguably, however, the biggest anticipated impact was to be increased foreign involvement in the United States market. The SEC indicated that

[t]he Rule may have significant implications for offerings by foreign issuers. Foreign issuers who previously may have foregone raising capital in the United States due to the compliance costs and liability exposure associated with registered public offerings, and the costs of financing inherent in placing restricted securities, may find private placements in the United States a more viable capital-raising option as a result of the combined effect of proposed Rule 144A and proposed Regulation S.⁷²

⁶⁸ See *supra* note 17.

⁶⁹ One commentator contends that the thought that "liquidity can be achieved merely by removal of regulatory impediments to free transferability" misperceives the reality of the financial marketplace; "[r]eal liquidity requires market breadth and a steady and reliable flow of timely public information." Cooper, *supra* note 50, at 16.

⁷⁰ Glover, *supra* note 67.

⁷¹ *Id.*

⁷² Securities Act Release No. 33-6806 (Oct. 25, 1988), 53 FED. REG. 44016, 44022 (1988).

Thus the SEC hoped that foreign companies heretofore reluctant to subject themselves to the rigors and expense of United States registration would be attracted by a more efficient and less expensive capital market. The SEC expected the increased participation by foreign issuers in the United States capital market to reduce the costs borne by United States institutional investors forced to go overseas to obtain foreign securities, as well as to afford United States intermediaries "more opportunities to participate in the internationalization of investment strategies."⁷³

C. *The Reality of Rule 144A*

So far, Rule 144A has been unable to live up to expectations: few large transactions have been completed; the rule has not generated significant liquidity; there has been little trading activity in privately placed securities; PORTAL has few subscribers and the number of securities traded on the system are small; the spread between public and private markets has not narrowed significantly; documentation associated with the new deals is almost as complex as that required in deals of old; and foreign issuers seem somewhat hesitant to enter the new market.⁷⁴

Some resistance from participants in the financial marketplace could be expected. Traditionally, institutional investors favored the private placement market because issuers were forced to offer high yields to compensate for the illiquidity associated with restricted securities.⁷⁵ Yet some institutions, like pension funds and insurance companies, do not need additional liquidity and are hesitant to lose their yield advantage over the public market.⁷⁶ Additionally, some institutions have no desire to sacrifice the ability to negotiate the terms of the securities with the issuer in order to utilize a computer-based trading system.⁷⁷ Furthermore, some resistance to Rule 144A reflects declining transaction costs; investment bankers, lawyers, and other intermediaries who heretofore have profited by guiding clients through the complexities of SEC

⁷³ *Id.*

⁷⁴ Glover, *supra* note 67.

⁷⁵ Investors were able, through negotiation, to obtain more restrictive covenants and higher spreads from issuers because of privately placed securities' relative illiquidity. Gillen, *supra* note 60.

⁷⁶ Bush, *Issuers Greet Rule 144A with Two Cheers*, Fin. Times, June 6, 1990, § 1, at 38.

⁷⁷ Wayne, *Few Subscribe to Private Trading System*, N. Y. Times, June 5, 1990, at D4, col.4.

regulation of private placements could be adversely affected by the adoption of the rule.⁷⁸

Perhaps what should be expected is hesitance among market participants rather than a sudden, significant transformation of the marketplace. United States investors are not accustomed to buying securities issued by a foreign company due to foreign issuers' relative inactivity in this country.⁷⁹ Additionally, foreign issuers are watching investors to see how they respond to Rule 144A. Some investment bankers are pleased with issuers' cautious response attributable to investor reluctance, reasoning that if a large number of corporations issued securities which failed to sell, such early negative impact on the new market would be enormous.⁸⁰

Rule 144A's mild reception is due in part to a bad market. The volume of all private placements are down;⁸¹ rising interest rates, the crisis in the Persian Gulf, and a reduction in high-yield investing by insurance companies⁸² have slowed growth in the private placement market. Corporations seem reluctant to do any kind of offering in today's unsettled economic climate. Foreign private placements, however, are up due to Rule 144A.⁸³

Securities issued in private placements under Rule 144A have been predominantly those of foreign issuers. Rule 144A allows foreign companies to issue equity through a private placement without the costly process of producing documentation conforming with United States Generally Accepted Accounting Principles (GAAP). Foreign companies seeking to avoid onerous United States registration requirements find the prospect of Rule 144A issues quite appealing.

⁷⁸ Note, *supra* note 14, at 261.

⁷⁹ Milligan, *Two Cheers for 144A*, INST'L INVESTOR, July 1990, Corp. Fin. section, at 118.

⁸⁰ Bush, *supra* note 76, at 39.

⁸¹ Star, *Banks Gain in Private Placements*, PENSIONS & INVESTMENT AGE, Sept. 17, 1990, at 3. IDD Information Services Inc. of New York indicates that domestic private placement financings in 1990 dropped for the first time in more than ten years. In 1980, private placements accounted for 22% of the \$73.3 billion United States securities market. By 1989, that share had grown to 38% of the \$479.5 billion total market. Yet during the first half of 1990, private placements had only a 26% share of the total market; overall private placement volume dropped to \$56.8 billion from \$84.1 billion during the same period in 1989.

⁸² This reduction can be attributed in part to stricter capital guidelines and a new rating system implemented by the National Association of Insurance Commissioners. 1990 *in Review*, 26 CORP. FIN. WEEK 51, 4 (Dec. 24, 1990).

⁸³ *Id.*

The SEC contends that the rule is successful in its attempt to attract foreign issuers.⁸⁴ On the day the SEC adopted both Regulation S and Rule 144A, SEC Chairman Breeden asserted that "[t]hese rules should benefit both U.S. investors and U.S. companies issuing securities, while making it much more practical for foreign companies to begin offering securities in the U.S. capital markets."⁸⁵ As of now, foreign issuers seem to be the primary beneficiaries of the new rules.

Rule 144A "raises the profile of the U.S. capital market" with foreign issuers by providing these issuers with easier access to the United States market.⁸⁶ Formally acknowledging the institutional resale market for the first time, Rule 144A officially recognizes "the ability of professional institutional investors to make investment decisions without the protection mandated by the registration requirements of the [1933] Act."⁸⁷ Rule 144A makes the United States market more appealing to foreign issuers because they do not have to contend with the onerous registration process. Yet despite this enhanced appeal, at this point not many would agree with one investment banker who proclaimed Rule 144A to be "one of the most, if not the most, significant pieces of deregulation since 1933. . . ."⁸⁸

The development of the 144A market probably will be an "evolutionary process," ultimately resulting in some business shifting from the European to the United States market.⁸⁹ Indeed, one former SEC official who helped draft the new rules notes that while Rule 144A and Regulation S should make international capital-raising easier, they remain "only the first steps to truly efficient regulation of the capital markets."⁹⁰ It will take time for foreign companies to understand these new rules that make it easier and cheaper to raise capital in the United States.⁹¹ Investors need to become more familiar with the rules before

⁸⁴ Preliminary figures quoted by Richard Kosnick, head of the SEC's international office in the Division of Corporation Finance, indicate that foreign issuers have done 80% of the \$2.6 billion in securities placed under 144A. *Rule 144A Succeeding in Drawing Foreign Issues: SEC*, 27 CORP. FIN. WEEK 3, 2 (Jan. 21, 1991).

⁸⁵ Wayne, *supra* note 26.

⁸⁶ Brady, *supra* note 50, at 58.

⁸⁷ Securities Act Release No. 33-6806, (Oct. 25, 1988), 53 FED. REG. 44016, 44026 (1988).

⁸⁸ Brady, *supra* note 50, at 58.

⁸⁹ *Rule 144A Will Shift Some Euromarket Business to U.S.*, 3 INT'L SEC. REG. REP. 11, 1 (May 7, 1990).

⁹⁰ Hanks, *SEC's Unanimous Adoption of Rule 144A and Regulation S*, 3 INT'L SEC. REG. REP. 7, 5 (April 23, 1990).

⁹¹ A director for the Private Placement Information Network, a computer-based

the demand for 144A securities significantly increases.⁹² Nevertheless, these actions demonstrate that the SEC is not merely keeping its watchful eye focused inward on the domestic market. Rule 144A, Regulation S, and PORTAL represent an attempt to address the growing internationalization of the financial marketplace.

IV. CONCLUSION

Many proclaimed the adoption of Regulation S and Rule 144A and the approval of PORTAL to be revolutionary.⁹³ Richard Breeden,⁹⁴ the current chairman of the SEC, predicted after the adoption of the changes that "[t]hese rules will have a profound and beneficial effect on the ability of issuers to raise capital in the context of today's global marketplace and enhance the competitiveness of our domestic market. The result should be a lower cost of capital on our markets."⁹⁵ Because this market transformation has yet to be realized, some doubt the significance of the new rules.

The rules, however, have succeeded in attracting foreign issuers, a principal purpose behind their adoption.⁹⁶ It will take time for foreign issuers to become familiar with the rules and how they can be utilized to tap the United States capital pool. It will also take time for United States investors to become comfortable with the prospect of buying securities issued by foreign companies. One should not equate a slow start with insignificance; even if these rules do not meet the great

service designed to provide information on privately placed securities, notes that "[t]here's normally a lag of two, three, or four years before people really figure out a rule change and then figure out what to do with it." *Electronic Bulletin Board for Private Placements Claims 85 Participants*, 10 BONDWEEK 40, 8 (Oct. 8, 1990).

⁹² Brady, *supra* note 50, at 58. Investor uncertainty probably will restrict the initial liquidity of the market. *Id.*

⁹³ In addressing the 21st Annual Institute on Securities Regulation, Edward F. Greene, an SEC Commissioner participating in the program, chose to emphasize that "the staff and the Commission have revolutionized how we look at the [1933 Act]." Greene, *Reproposed SEC Rule 144A*, 21 INST. ON SEC. REG. 4 (1990).

⁹⁴ Breeden is also chairman of the International Organization of Securities Commissioners (IOSCO). Bush, *New Rule Will Clear a Path - The Growing U.S. Private Placement Market Has Received a Spur*, Fin. Times, (July 2, 1990), at V.

⁹⁵ *Id.*

⁹⁶ One commentator asserts that expectations of an expanded market for primary private placements, substantially less burdensome disclosure, and improved liquidity of privately placed securities result from misperceptions of the principle objective of the rule's proponents; the facilitation of "mutual access between U.S. institutional investors and foreign securities issuers." Cooper, *Misperceptions of a Move to Globalization*, PENSIONS & INVESTMENT AGE, Oct. 29, 1990, at 16, 17.

expectations which accompanied them, by adopting them the SEC demonstrated a determination to become involved in maintaining the United States market's prominence by addressing the unavoidable reality that the marketplace has become global and will continue to develop as such—with or without United States involvement.

The SEC must determine whether United States competitiveness in a global financial marketplace should be a primary concern. Their current efforts to achieve such are not without costs. For instance, it will be difficult to reconcile easing rigid accounting and disclosure requirements for foreign companies while holding domestic corporations to higher standards.⁹⁷

If the SEC determines that this path should be followed, however, it needs to be receptive to input from market participants and willing to develop a system of regulation that will enable the United States market to be both attractive to foreign investors and competitive internationally. The SEC can do nothing about the economic recession which has quieted activity in the United States capital market; it can, however, clarify elements of the rules which remain ambiguous, eliminate elements unnecessary for investor protection which impede international participation, and amend the rules to further encourage foreign issuers and investors if they truly want to make the United States securities market competitive internationally. If these rule changes and any further evolution which may occur do not achieve these desired effects, the SEC must contemplate more drastic measures⁹⁸ to ensure an active presence in the international capital marketplace.

R. Brandon Asbill

⁹⁷ Dutt, *Going Global; Markets Make Foreign Stocks a Top Priority*, *NEWSDAY* (Jan. 21 1991), at 33. Former SEC chairman David Ruder shares this concern: "to the extent that you relax SEC rules and regulations to mollify international issuers . . . to what extent will this create competitive burdens for domestic companies in [the U.S.] market?" *Implementation of Rule 144A and Reg. S Expected Soon*, 3 INT'L SEC. REG. REP. 8, 2 (March 26, 1990).

⁹⁸ The SEC and the Japanese Ministry of Finance recently agreed to discuss reciprocal recognition of disclosure documents which will allow a Japanese corporation to issue securities in the United States market and a United States corporation to do the same in Japan. *U.S., Japan Set to Target Trading Abuses*, *JAP. ECON. J.*, (Jan. 19, 1991), at 32. If an agreement can be reached, the SEC should consider extending the same privilege to members of the European Community.

