REGULATION S - RULES GOVERNING OFFERS AND SALES MADE OUTSIDE THE UNITED STATES WITHOUT REGISTRATION UNDER THE SECURITIES ACT OF 1933

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by

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L.L.B., B.COM., The University of Canterbury, New Zealand, 2000

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CHAPTER ONE

Introduction

Underpinning any regulatory regime is a dichotomy between achieving certainty of outcome and achieving a perceived fairness. While such a discussion may seem out of place in the context of a regulatory regime dealing with offshore offerings, it nonetheless serves to emphasize some of the considerations encountered in the following examination of Regulation S1.

Part Two of this thesis outlines the development of the disclosure regime that is evidenced in the United States Federal Securities Regulations and then goes on to examine how this regime, first established in the 1930s, dealt with the advent of globalization. Part Three then looks at Regulation S, introduced in 1990. An overview of the Regulation is provided, followed by a detailed examination of the various provisions of the Regulation. The thesis then moves on to Part Four which sets out some of the more common abuses that began to occur shortly after the introduction of Regulation S, and also notes some of the marketplace concerns regarding the operation of the Regulation. Part Five details the events, criticisms and SEC releases that led up to the amendment of Regulation S in 1998, before Part Six deals with the actual amendments themselves in some detail. As it has only been a relatively short time since the adoption of the

amendments, Part Seven assesses the probable impacts which the amendments may have on both the abuses and the marketplace concerns. Following on from this, Part Eight provides recommendations should the abuses and concerns continue after the amendments. Part Nine calls into question the desirability of applying American securities laws extraterritorially and discusses various approaches to the international regulation of securities before the brief conclusion in Part Ten.
CHAPTER TWO

The Need For Disclosure

Securities by their very nature are intangible and do not possess any extrinsic value. Instead, their value comes from the rights which they bestow on their holder, entitling the owner to vote and also to make claims upon both the assets and income of the issuer. Therefore, a prospective purchaser of securities presumably needs as much information as possible relating to the issuer so as to be better able to make an informed investment decision.

In the United States, the collapse of the securities market in 1929 provided the impetus for the creation of a mandatory federal disclosure system. The Securities Act\(^2\), introduced in 1933, is concerned with public offerings and the sale of securities via the means of interstate commerce.

The underlying philosophy behind the Act was that of disclosure, as it was assumed that disclosure would prevent the flotation of fraudulent securities as had been seen in America between 1919 and 1929. During this period many investors saw their life savings evaporate in securities that were often worthless. The 1933 Act prohibited both the offering and sale of a security that had not been registered with the Federal Trade Commission (later, the Securities Exchange Commission (SEC)) and, further, the Act

required that a prospectus be available to all potential investors to whom the offer was made. In short the prospectus is an attempt to provide issuers with all the necessary information so as to make an “informed” investment decision.

The Securities Exchange Act of 1934\(^3\), by comparison, is more concerned with the protection of secondary market trading but it too also contains mandatory disclosure requirements.

However the United States’ mandatory disclosure regime has not been without criticism. Many commentators\(^4\) have suggested instead that there are sufficient market motivations for managers to disclose information and thus that there is no need for federal intervention in securities markets.

Issuers, however, have often sought to avoid the registration provisions of the 1933 Act. One way of doing so has been to seek refuge in one of the so called “safe harbors”, which, if satisfied, have the effect of not requiring the issue to be approved by the SEC before being offered and sold. One such safe harbor is Regulation S.\(^5\)

\(^3\) 15 U.S.C. s78a – 78gg (1994)
\(^4\) JAMES D. COX ET AL., SECURITIES REGULATION 43 (3d ed. 1997) where it is noted that “the mandatory disclosure requirements of the ’33 and ’34 Acts have not escaped the criticism of those who prefer Adam Smith’s invisible hand to the heavy regulatory hand of the federal securities laws”.
See also Homer Kripke, The Myth of the Informed Layman, 28 BUS. LAW. 631 (1973) and A.A. Sommer, JR., A Program by the ABA Committee on Federal Regulation of Securities, 36 BUS. LAW. 119 (1980) reprinted in LARRY D. SODERQUIST & THERESA A. GADALDON, SECURITIES REGULATION 113-120 (4th ed. 1999) where comments are made by Sommer and Kripke that disclosure does not need to be addressed by a federal body, but instead that there are more sufficient market incentives for disclosure to take place.
\(^5\) Original Regulation S, supra note 1.
Globalization

The 1980s and 1990s have witnessed the advent of a truly global marketplace. “Through decreased communication costs and improved international financial connections, investors and issuers are able to shift capital quickly from one country to another.” Essentially, Regulation S came about because of ever increasing globalization as the increasing volume of international transactions placed strains on the previous system of extraterritoriality.

The move to a global capital market raises many challenges and potential problems. It has been suggested by commentators that;

The traditional goal of securities regulation, investor protection, may have to be tempered in a “global market” by (1) the desire of U.S. investors to invest and trade in foreign securities, (2) the reality that they may do so outside the United States, and (3) the importance to the United States of maintaining the world’s leading domestic capital market, which requires openness to foreign issuers [and foreign investors].”

The introduction of Regulation S is an example of this. investor protection through disclosure takes a backseat to the goals of reducing the cost of raising capital offshore and enhancing the attractiveness of the U.S. securities market to overseas investors.

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7 HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE; TRANSACTIONS, POLICY, AND REGULATION 32 (4th ed 1997)
An example of globalization in the United States was the increase in purchases and sales by US investors of foreign equities from an estimated $17.9 billion in 1980 to $741.6 billion in 1995.8

Even the SEC acknowledged the trend when it talked of “the development of active international trading markets and the significant increase in offshore offerings of securities, as well as the significant participation by U.S investors in foreign markets.”9

So it is obvious that the rapid expansion of the global marketplace changed the U.S. capital markets dramatically. Foreign issuers have sought to offer their securities to U.S. investors. U.S. investors have looked to invest in offshore offerings and U.S. issuers have sought to offer their securities to overseas investors, often for the purposes of raising capital.

In this thesis the regulatory problems posed by offerings which occur outside of the United States are examined.10

United States Federal Securities Regime

The two canons of securities regulation in the United States are full and fair disclosure11 and the concept of registration. Relying on the theory of disclosure12 and the underlying

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10 i.e. Offshore Offerings
11 See discussion infra Part II.A
12 Id.
assumption that an investor can make up his own mind if he has all the material facts, the U.S. securities system does not address the fairness of a transaction.

Section 5 of the Securities Act\(^\text{13}\) forms the cornerstone of the Act. In general terms section 5 prohibits the offering and sale of securities until a registration statement regarding the security has been approved by the SEC.\(^\text{14}\)

Generally, a registration statement relating to the public offering of securities must be filed with the SEC before the issuer (or persons in control relationships with the issuer) can offer the shares to the U.S. public. In the registration statement information is provided about the issuer, the security itself and the use to which the proceeds from the offering will be put, amongst other details. Thus, until the offeror of the securities has satisfied the SEC no sale of the securities can take place. As a result the United States is widely regarded as having a particularly onerous registration process with the cost of complying with the Securities Act adding significantly to the cost of the issue.

Section 5 of the Securities Act 1933 provides for prohibitions relating to “Interstate Commerce”. It states that unless a security has a registration statement it is unlawful for any person to use Interstate Commerce to sell the security. Interstate Commerce is defined in section 2(7) of the same Act as meaning:

\[
\text{[T]rade or commerce in securities or any transportation or communication relating thereto among the several States or between the District of Columbia or any Territory of the United States and any State or other Territory, or between any foreign country and any State, Territory, or the District of Columbia, or within the District of Columbia.}\]

\(^{13}\) 15 U.S.C 77(e) (1994)
\(^{14}\) 15 U.S.C. 77 c-e (1994) Section 5 states that any offer or sale of securities using interstate commerce must be registered unless some form of exemption can be granted.
Taken literally, it would not be difficult to believe that any offering whatsoever, even if undertaken offshore, would come within section 5 if at some stage the US mail system or telephone system\textsuperscript{16} were used in the process of selling the securities abroad. Thus, for example, if foreign issuer made telephone calls to the United States in the course of selling securities then that would seemingly also come within section 5 by virtue of the broad definition of interstate commerce.

However, such a literal interpretation (potentially giving section 5 a worldwide reach) would be unworkable, to say the least, as it would imply that a public offer or sale of securities anywhere in the world that involved the use of US interstate commerce must be registered with the SEC. Not only would this strike fear into the hearts of foreign issuers, it would also cause problems with foreign regulatory regimes as well as creating enforcement problems. Yet given that the Securities Act was enacted in an era largely before the advent of international offerings, it is not then surprising to find such an extra-territorial reach contained within the legislation.

Securities Act Release 4708\textsuperscript{17} was the SEC’s first attempt at clarifying to what extent the legislation was extraterritorial. In this short interpretative release the Commission set out the view that the registration requirements of the 1933 Act were largely for the benefit of American investors.

Issued in 1964, during the development of the Eurobond market, Release 4708 stated that if the “offering is made under circumstances reasonably designed to preclude

\textsuperscript{16} Or any other means of modern communication such as the Internet, e-mail and faxes.
distribution or redistribution of the securities within, or to nationals of, the United States”, then registration would not be required under section 5. Therefore, in Release 4708, the SEC stated that it would not bring an action for the failure of U.S. corporations to register securities distributed offshore to foreign nationals, even if the means of interstate commerce were involved.

However, in spite of this, the position adopted by the SEC was still not entirely clear as the SEC did not provide any legal or economical reasoning to explain its position other than that the registration requirements were created to protect American investors. This ensuing uncertainty resulted in a number of “no action letters”18 where the SEC interpreted and re-interpreted Release 470819 but failed to shape the policy. “Most companies were compelled to seek an individualized determination by the Commission’s staff that their particular offerings would not be deemed to occur in the United States”.20 The position was not clarified until Regulation S was adopted in 199021

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18 A “no action letter” is a guarantee from the SEC that it will not bring action against the issuer for being in breach of section 5. Such a letter is a costly exercise to undertake and also does not provide a clear precedent for other issuers to rely on.
19 JENNINGS, supra note 8, at 577.
CHAPTER THREE

Brief Overview of Regulation S

With the release of Regulation S in 1990 the SEC intended to help large American corporations in selling their securities to foreign investors, with the foreign investors anticipated to hold such securities for a considerable period of time. By exempting such issuers from registering under the Securities Act, the SEC set up a territorial regime, as opposed to the extraterritorial approach that was implicit under section 5. Regulation S provides guidance on which securities transactions conducted outside the United States may come under the reach of section 5.

In limiting the span of section 5, the SEC stated that “principles of comity and the reasonable expectations of participants in the global markets justified reliance on laws applicable in jurisdictions outside the United States to define requirements for transactions effected offshore.”

22 L Cohen, Rules Permitting Offshore Stock Sales Yields Deals That Spark SEC Concerns, WALL ST. J, Apr 26 1994 at C1, where Sara Hanks, a New York attorney who helped write Regulation S, commented “the rule was intended to help big, healthy companies sell bonds and stock to long term European investors”.
23 The principle of comity emphasizes restraint and tolerance by nations in international affairs.
24 Adopting Release, supra note 9, at 18314
Made up of Rules 901-904, Regulation S provided "safe harbors"\(^{25}\) for both foreign distributions and resales of unregistered securities of U.S. and foreign issuers.

The underlying policy rationale for the introduction of Regulation S was to reduce the cost of raising capital offshore by giving overseas markets greater accessibility to domestic issuers,\(^{26}\) especially in the light of the globalization trend. Essentially, it opened the door for domestic issuers to raise capital in the global market as opposed to limiting them to the internal market. Further, it increased the competitiveness of US issuers in the eyes of foreign investors.

Another reason for the introduction of Regulation S was to provide greater certainty for issuers – as under Release 4708 and the no action letters that followed, the exact position of the SEC was not evident.

But even though Regulation S was an attempt to tidy up the regulation of offshore capital, after its introduction it became evident that there were unintended loopholes in the regulation. These loopholes were essentially contrary to the stated intention of the SEC when it introduced Regulation S. As a result of the exploitation of these loopholes, Regulation S was not seen as an effective way of raising offshore capital. Eventually, as a result of the abuses, the SEC amended the regulation in 1998.\(^{27}\)

The amendments took place despite Preliminary Note 2 to Regulation S stating that the regulation is not available for "any transaction or series of transactions that, although in

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\(^{25}\) i.e. an exemption from the 1933 Securities Act registration requirements

\(^{26}\) Cohen, supra note 23.

technical compliance with the rules, is part of a plan or scheme to evade the registration provisions of the Act". So it is arguable that this provision provides the SEC with sufficient powers to intervene in situations where they see Regulation S being used in any unintended matter, irrespective of whether the safe harbors have been satisfied.

What follows in this paper is an examination of the existing Regulation S together with the abuses of it. Following that, the changes will be examined in light of the abuses to see if they will actually address the apparent problems.

**Regulation S Details, 1990 – 1998**

Fundamentally, Regulation S is made up of a general statement provided in Rule 901, definitions in Rule 902, and two non exclusive “safe harbors” in Rules 903 and 904.

Rule 901 provides that offers and sales of securities which do not take place in the U.S. are not subjected to the registration requirements of the Securities Act. Rule 903, known as the “issuer safe harbor”, creates a safe harbor for distributors (i.e. participants in a distribution such as issuers, underwriters and the like). Essentially, it classifies issuers into one of the three categories on the basis of the relative likelihood that the securities of that issuer will enter the US markets to trade. Meanwhile Rule 904, known as the “resale safe harbor”, creates a safe harbor for resales by others. This

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28 *Id.* at Preliminary Note 2
29 Original Regulation S, *supra* note 1. Note that “Rule 901” refers to s230.901.
30 *Id.* “Rule 903” refers to s230.903, and “Rule 904” refers to s230.904.
31 *Id.* with “United States” being defined in s230.902(p)
32 *Id.* at s230.903
includes investors who procure securities through a private placement in the US or in a transaction that is exempt from registration under Rule 144A\textsuperscript{33}. Thus, Rule 904 concerns itself with whether the purchase of an unregistered security abroad has in fact been underwritten and then resold to an American.

A. \textit{The General Statement the Offers and Sales of Securities outside the US are not subject to the Registration Requirements of Section 5, as outlined under Rule 901, Original Regulation S.}

Rule 901 contains the general statement which provides that registration requirements under section 5 do not apply to offers or sales of securities outside the U.S. It states that:

For the purposes only of Section 5 of the Act, the terms “offer”, “offer to sell”, “sell”, “sale”, and “offer to buy” shall be deemed to include offers and sales that occur within the United States and shall be deemed not to include offers and sales that occur outside the United States.\textsuperscript{34}

The determination of whether an offer and sale is made outside the United States is made on an ad hoc basis. If the offer and sale satisfy the conditions of either of the safe-harbor provisions in Rules 903 or 904, such a transaction will be deemed to have occurred outside the United States and will therefore not be subject to the registration requirements of section 5.

\textsuperscript{33} 17 C.F.R. 230.144A (1997). Rule 144A was adopted by the SEC on April 19 1990. It establishes an exemption from the registration requirements of the Securities Act for qualifying resales to ‘qualified institutional buyers’ of securities that were not fungible (i.e not of the same class) at the time of issuance with a class of securities publicly traded in the United States.

\textsuperscript{34} 17 C.F.R. Section 230.901 (1996)
B. Two General Conditions required under the Issuer and Resale Safe Harbors

All offers and sales, whether made in reliance on the issuer or the resale safe-harbor, must satisfy two general conditions in order to be considered outside the United States. In addition, the issuer must satisfy specific conditions that are set out in each safe-harbor provision.

First, any offer or sale of securities must be made in an "offshore transaction". Rule 902 (h) provides that an offer or sale is made in an offshore transaction if the offer is not made to a person in the United States\(^{35}\) and if either of two additional requirements are satisfied.

The first of the alternative requirements is that the buyer is outside the United States, or that the seller reasonably believes that the buyer is outside of the United States, at the time the buy order is originated.\(^{36}\) The second alternative means of satisfying the offshore transaction requirement is to execute the transaction on a designated offshore securities market\(^{37}\). However, if the seller or its agent knows that the transaction has been prearranged with a buyer in the United States, the second alternative will not be satisfied\(^{38}\).

\(^{35}\) But see 230.902(h)(B)(2) states that "offers and sales of securities specifically targeted at identifiable groups of U.S. citizens abroad, such as members of the U.S. armed forces serving overseas, shall not be deemed to be made in "offshore transactions".  
\(^{37}\) These non U.S. securities exchanges and markets are listed in 17 C.F.R. s 230.902 (1996) 
The second general condition that must be satisfied in order for an offer and sale to be considered outside the United States is that there be no direct selling efforts in the United States.

Therefore, if a transaction satisfies the two general conditions (namely that it takes place offshore and that there is no directed selling in the United States), then it may well qualify for an exemption from registration under one of the following safe harbors.

C. Issuer Safe Harbor

Concerning itself with the likelihood that the issuer’s securities will enter the US market. Rule 903 is applicable to offers and sales by issuers, distributors and their affiliates or any persons acting on their behalf. The safe harbor is available to both U.S. and foreign issuers offering securities outside the United States.

The issuer safe harbor distinguishes among three categories of securities offerings “based upon factors such as the nationality and reporting status of the issuer and the degree of U.S. market interest in the issuer’s securities.” The first category applies to non U.S. issuers, including the securities of foreign issuers who have no substantial market interest in their securities in the US. The second category is applicable to securities of foreign reporting issuers who have a substantial market

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39 Defined in s 230.902(c) as “any activity undertaken for the purpose of ... conditioning the market in the United States for any of the securities being offered”
40 The greater the likelihood that the securities will flow back into the United States, the more difficult the procedural requirements necessary to avoid registration are.
41 Adopting Release, supra note 9, at 18307
42 17 C.F.R. s 230.903(c)(1)(1996)
interest in their securities in the U.S., and also to certain securities issued by nonreporting foreign issuers. Finally, category three applies to all issuers not under category one or two. This third category includes domestic nonreporting issuers and foreign nonreporting issuers who have a substantial market interest within the US for their securities. The more likely that the securities are going to enter the U.S. markets, the more onerous the category requirements are.

\[ i. \quad \text{Category One} \]

This issuer category, which applies to securities both offered and sold by foreign issuers having “no substantial US market interest” in their securities and also to securities offered and sold in “overseas directed offerings.” It also applies to securities backed by “the full faith and credit of a foreign government” and securities issued pursuant to employee benefit plans administered offshore.

Both offers and sales under this category do not require any further conditions to be satisfied other than the two general conditions discussed above. (namely that it be an offshore transaction and that there are no directed selling efforts in the US).

This category is the least onerous issuer safe harbor category because the SEC has taken the view that such offers are the least likely to be of risk to domestic US investors (that is, category one securities are unlikely to flow back to the United States).

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43 Id. at s 230.903(c)(2)
44 Id. at s 230.903(c)(3)
45 Id. at s 230.902(f)(1)
46 Id. at s 230.902(n)
47 Id. at s 230.903(c)(1) (ii), with an “overseas directed offering” being defined at s 230.902(j)
48 Id. at s 230.903(c)(1) (iii), with “foreign government” defined at s 230.902(e)
ii. **Category Two**

The second safe harbor for issuers under the original Regulation S is applicable to securities of domestic reporting issuers, foreign reporting issuers who had a substantial market interest in the U.S. for their securities, non-reporting foreign issuers (with respect to their debt securities) and non-participating preferred stock and asset backed securities of the non-reporting foreign issuers. This safe harbor only applies to equity securities of domestic, reporting issuers, and to foreign issuers with a “substantial market interest” in the U.S. for their securities.

Securities falling within category two are subject to the two general conditions and also several selling restrictions. Broadly speaking, these regulations can be divided into restrictions regarding transactions and restrictions relating to offerings.

Transactional restrictions necessitate that securities sold before the end of a 40 day restricted period are not offered or sold for the benefit of a US person. Thus distributors who sell securities to securities professionals require notice from the purchaser that they too are subject to the same requirements as the distributor.

A “U.S. person” is defined as “any natural person resident in the United States”. Therefore, it follows that any foreign or domestic national resident in the United States is classified as a U.S. person under Regulation S.

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49 Id. at s 230.903 (c ) (1) (iv)
50 Id. at s 230.903 (c ) (2)
51 Id.
52 That it be an offshore transaction and that there be no directed selling efforts in the U.S.
54 Id. at s 230.903(c ) (2)(iii), with “restricted period” being defined in s230.902(m)
55 Id. at s 230.903(o)(1)(i)
For corporations, the place of incorporation usually is controlling. But, the SEC has observed that if a corporation is organized or incorporated in a foreign jurisdiction by a US person, with the purposes of investing in securities not registered with the SEC, then such a corporation will come within the definition of a US person for the purposes of Regulation S.

Offering restrictions, of which there are two, must also be met under this second category. They must be adopted by the entire offering. First, every distributor is required to agree in writing that all offers and sales made before the ending of the restricted period will be carried out either in line with the safe harbor provisions of Regulation S, or in line with registration or an exemption. Secondly, all materials and documents used in connection with the offer and sale of the securities during the restricted period must contain a statement stating that the securities have not been registered and further that they may not be offered or sold in the U.S. to a U.S. person unless they are registered or there has been an exemption.

iii. Category Three

The third issuer safe harbor is essentially a residual provision for issuers that do not fall within the first two categories. Therefore, this category includes issuers of domestic

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56 Id. at s 230.902(o)(1)(ii)(v)
57 Id. at s 230.902(o)(viii)(A)-(B)
58 Id. at s 230.903(c)(3)(i), with “offering restrictions” being defined in s230.902(h)
59 Id. at s 230.902(h)(2)
nonreporting equity securities and foreign nonreporting issuers with a substantial market interest in the US for their securities.\textsuperscript{60}

Because category three is an attempt to protect against unregistered distributions when there is a possibility that the securities may flow back into the U.S. and where there is little information about the issuer, then the requirements having to be satisfied under category three are stricter than the other two categories.

As well as satisfying the two general conditions (namely of an offshore transaction and no directed selling efforts in the U.S.), securities coming within the third category are also required to satisfy the two offering restrictions, similar to category two, however the third category requires that the securities be subjected to a one year restricted period.\textsuperscript{61}

Further, the transactional requirements under category three are stricter than those under the second category. Purchasers are required to certify that they are not U.S. persons and further that they are not acquiring the securities for the benefit of a U.S. person.\textsuperscript{62} Purchasers are also required to agree to resell the securities only in line with the rules controlling Regulation S or pursuant to registration, or any other exemption.\textsuperscript{63}

Category three transactional restrictions also require that issuers state, by means of a legend, that the transfer of such securities is prohibited unless the transfer is in accordance with Regulation S.\textsuperscript{64} Aligned to this is the requirement that the issuer must

\textsuperscript{60} Id. at s 230.903(c)(3)
\textsuperscript{61} Id. at ss 230.902(h), 230.903(c) (3)(i)-(iii)(A)
\textsuperscript{62} Id. at s 230.903(c ) (3)(iii)(B)(1)
\textsuperscript{63} Id. at s 230.903(c ) (3)(iii)(B)(2)
\textsuperscript{64} Id. at s 230.903(c ) (3)(iii)(B)(3)
refuse to register any transfer of category three securities made outside Regulation S requirements. Furthermore, those distributors who are selling either equity or debt securities before the expiration date of the restricted period are also required to notify purchasers of their obligation to be subjected to the same restrictions on offers and sales that apply to the distributor.

D. Resale Safe Harbor

Irrespective of whether a sale of an unregistered security is made by an issuer or a subsequent purchaser, an exemption is required from the registration requirements. Rule 904 of Regulation S provides such a method for the resale of unregistered securities by providing a safe harbor for the offshore resale of unregistered securities by persons other than the issuer, distributor or their agents.

In order to be eligible for Rule 904, two general conditions must be satisfied – namely that the transaction takes place offshore and further that there be no directed selling efforts within the U.S. If these are satisfied, then the resale is taken as having occurred outside the U.S. for the purposes of the general statement and also the registration requirements.

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65 Id. at s 230.903(c)(3)(iii)(B)(4)
66 Id. at s 230.903(c)(3)(iv), the two restrictions are that it be an offshore transaction and that there are no directed selling efforts in the U.S.
68 17 C.F.R. s 230.904 (1996)
69 Id.
CHAPTER FOUR

Abuses Which Occurred After the Introduction of Regulation S

The intended users of Regulation S were sound domestic corporations seeking the placement of securities with long term offshore investors in order to compete in the global market place.70

But after one year the SEC filed its first enforcement action, involving violations of Regulation S.71 As increasing enforcement actions were brought, it became readily apparent that the loopholes in Regulation S had not only been widely discovered, but further that they exposed Regulation S to abuse, contrary to its stated intention as outlined above. Further, concerns arose on Wall Street.72 There have been a number of differing abuses of Regulation S. Detailed below are examples of different such abuses.

A. Illegal Resales within the Restricted Period.

Any resale of Regulation S securities back into the US before the end of a restricted period is a violation of Regulation S unless another exemption can be relied upon or registration has taken place.73

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70 Release 4708, supra note 17
72 J Scholl, Easy Money, BARRON’S, Apr. 29, 1996
73 Cohen, supra note 23, at ss 230.903(c)(2)(iii) and 230.903(c)(3)(iii)(A)
Liability can arise when the restricted period is not adhered to. In one case a broker was fined US$150,000 by the regulatory arm of the National Association of Securities Dealers (NASD) because one of the brokerage’s customers had purchased Regulation S securities and then sold them back in the US, via the broker’s accounts, before the end of the restricted period for the securities. The broker in this case was fined for failing to make the necessary “affirmative determination” – such as marking on the order form where the shares were located and whether the shares were in a deliverable form – in determining whether the securities would be within the restricted periods, before carrying out the sales.

B. Creation and Use of Fake Offshore “Parking” Entities as a Means for Selling Unregistered Securities in the US.

In another abuse of Regulation S, a phoney offshore “parking” entity has often been created as a means for an issuer or distributor to directly profit from the sale of the unregistered securities back into the US.

Under such a scheme, Regulation S is stated as the basis for selling securities to offshore shell companies formed, in many cases, by the issuer or distributor. The offshore shells then hold the securities for the restricted period before selling them into

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74 In re Alex Brown & Sons, Inc., No.CMS 960084 AWC (NASD)
the US. The proceeds of the sale then make their way, either in a direct or indirect manner, to the issuer or distributor.\textsuperscript{77}

The SEC, however, has taken the view that such transactions do not come within Regulation S because they are "nothing more than sham offshore transactions structured to evade the Securities Act registration requirements".\textsuperscript{78} In the case \textit{SEC v Softpoint Inc.}\textsuperscript{79}, Softpoint was charged by the SEC with a variety of violations, including participating in a number of transactions that sold Regulation S securities that were not registered in the US, and then "dressed up" the proceeds as earnings from corporate sales.

In order for this to take place, the SEC alleged that Softpoint issued Regulation S securities to offshore distributors who in fact had been either formed or controlled by Softpoint. By doing so, Softpoint was able to indirectly control the sale of the securities by the offshore distributors back into the US. The earnings received were fictitiously claimed as being from product sales.\textsuperscript{80}

In the \textit{Softpoint} case the court noted that Regulation S only provided a safe harbor for ""bona fide" overseas transactions, in keeping with the intention expressed in Preliminary Note 2. Regulation S was not a mechanism for foreign securities distributions to evade the registration requirements of Regulation S. Therefore, it was held that Softpoint did not undertake bona fide offshore transactions, and therefore could not rely on the safe harbor provisions of Regulation S.

\textsuperscript{77} \textit{Id.}
\textsuperscript{78} \textit{SEC v Softpoint Inc, SEC Litigation Release No. 14480, 59 SEC Docket 426 (S.D.N.Y. Apr.27 1995)}
\textsuperscript{79} \textit{Id.}
\textsuperscript{80} \textit{Id.}
In another case, *United States v Sung*\(^8^1\), an offshore shell was created in order to profit from the sale of Regulation S securities. This case was notable as it was the first time a criminal conviction was imposed for fraud involving Regulation S. Both the former chairman and his associate were convicted.

For a three month period in 1992, the chairman of Sung saw that over 1.4 million shares of unregistered common stock were issued, pursuant to Regulation S, in the name of a 95 year old woman, presumably at a discount to their trading price. This account was controlled by the associate. The chairman also saw that a further 1.2 million shares were issued to seven shell entities he controlled in the Bahamas. After doing so, the chairman then proceeded to stimulate the price upwards by issuing deceiving financial statements and untrue press statements.\(^8^2\) When the share price was deemed high enough by the chairman and his associates, they then proceeded to sell the stock in the U.S. market for around $5.5 million.\(^8^3\)

C. The Use of Promissory Notes in Purchasing Regulation S Securities when the Expectation of Repayment Stems from the Regulation S Securities back into the U.S. Market

Yet another situation where Regulation S abuses have occurred involves the use of Promissory Notes. In this situation, an offshore investor would purchase discounted Regulation S shares after signing a promissory note that was interest free and short term

\(^8^1\) SEC Litigation Release No. 14901, 61 SEC Docket 2275 (M.D.Fla May 6 1996)
\(^8^2\) *Id.* at 2275
\(^8^3\) *Id.*
in nature. After the expiration of the restricted period (which in most cases was 40 days), the offshore investor would sell the shares into the U.S. market. With the money received from the sale, the promissory note could be paid off, and then any amount left over (which there was in most cases because the shares were usually discounted from the prevailing market price when originally sold offshore) would be profited by the offshore investor. In essence, this meant not only that the foreign investors received the shares for nothing, but that they were making a profit out of the transaction as well.

In the case *In the Matter of Candie's, Inc.* administrative proceedings were brought by the SEC against the two issuers involved (a women's footwear company and a security company), a law firm and also the head of a brokerage. The proceedings were brought for “alleged violations of the securities laws involving the use of promissory notes in the purchase of Regulation S securities”. Here, the issuers sold shares by seeking the Regulation S exemptions, via both a law firm and a brokerage firm to foreign investors at a discount. In return, the foreign companies granted short term, unsecured promissory notes. At the conclusion of the appropriate restricted period, the stock was sold by the foreign companies back into the US via the brokerage firm, and the promissory notes were paid off by a part of the proceeds of the sale.

Here, the SEC found the offerings were in fact a scheme designed with the intention of avoiding registration, and thus found them not to be offers and sales of

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85 *Id.* at 759
86 *Id.* at 761
securities protected by Regulation S. The foreign participants were found to have been engaged essentially to provide protection for the sale of unregistered securities in the US. This case was significant because it marked one of the earliest cases where, under Regulation S, the SEC found that the regulation was violated, in spite of there being no fraud or violation of the regulation itself. Instead, the SEC viewed the transactions as being schemes "to evade the registration requirements of the federal securities laws". This interpretation was reached by an examination of Preliminary Note 2 of Regulation S.

D. The Use of the Resale Safe Harbor to "Wash Off" Restrictions from Otherwise Restricted Securities

Another example of how investors use the Resale Safe Harbor to "wash off" the restrictions placed on Regulation S securities under the restricted period is where investors take securities which are restricted and cannot be sold publicly within the U.S. and then, relying on the provisions relating to the resale safe harbor, sell the securities offshore.

In its "Problematic Practices Release"\(^8^8\), the SEC outlined such a practice and then forbade it on the grounds that the resale safe harbor could not be used in such a way so as to "wash off" any restrictions on resale.\(^8^9\) In its release, the SEC stated that "if a person with restricted securities sold the securities in an offshore transaction and replaced

\(^{8^7}\) Id. at 763  
\(^{8^8}\) See supra note 77  
\(^{8^9}\) Id. at 35671
them with a repurchase of fungible unrestricted securities\textsuperscript{90}, then the securities which acted as a replacement would in fact be subjected to the same restrictions as those they replaced.

\textbf{E. The Use of Hedging as a Means to Lock in Profits Associated with Discounted Purchases Under Regulation S}

Yet another way in which Regulation S was subjected to abuse was via hedging. Also known as “short-selling”\textsuperscript{91}, hedging occurs where an overseas investor would buy a certain amount of Regulation S stocks, usually at a significant discount, and then would instantaneously sell short the same shares for the market price. By doing so, the offshore investor would “lock in” the difference between the discounted price and the market price, while at the same time not being subjected to any of the risks involved with waiting due to the restricted period. At the time when the offshore investor closes out the short positions (at the conclusion of the restricted period) the Regulation S shares are then sold back into the US for the market price, with the proceeds of this sale being used to cover the short positions by purchasing the same number of shares at the market price. Such a practice is known as a “wash”.

\textsuperscript{90} \textit{Id}

\textsuperscript{91} Selling short occurs when an investor sells a security that he does not own but is committed to repurchase eventually. Investors first borrow stock from willing broker-dealers then the investors sell the borrowed stock in the marketplace. Later, investors must replace the borrowed stock either through purchases of the stock on the open market or, as in the GFL Ultra scenario, through Regulation S stock purchased earlier once the stock becomes eligible for trades in the United States. Investors use short sales to capitalize on an expected decline in a security’s price.
In the case *In the Matter of GFL Ultra Fund* the British Virgin Islands investment company operated under a strategy of immediately short selling Regulation S stocks at a discount. The strategy specifically involved the purchase of securities of U.S. issuers at substantial discounts in offshore transactions pursuant to Regulation S and hedging some or all of these transactions through short selling in the United States before or during the 40 day restricted period applicable to the Regulation S transactions. The company subsequently unwound these short positions either through covering the short sales with Regulation S shares themselves, or by selling the Regulation S shares in the U.S. secondary market following the restricted period and purchasing other shares in the open market to cover the short positions. The result of such a strategy, according to the SEC, was that the company had a profit at the end of the trading by virtue of it locking in its profits when it took its short positions.

This transaction was found to have been a violation of the Securities Act, with particular reliance placed on section 5. It came within section 5, because, in the view of the SEC, covering a short position was the same as a “sale” for the purposes of section 5. In reaching this position, the SEC also took account of the numerous exemptions which GFL Ultra sought to rely on. However, it dismissed all the possible exemptions. Section 4(1) concerning private placements did not apply because the company was a “statutory underwriter”, as defined under section 2(a)(11) of the Securities Act. This

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92 Administrative Proceeding Release No. 3-9333, 64 SEC Docket 1958 (June 18, 1997)
93 Id.
94 Id.
95 15 U.S.C. s 77d(1) (1994). This section exempts transactions by any person other than an issuer, underwriter or dealer from the provisions of section 5.
96 15 U.S.C s 77b(11) (1994)
section defines an underwriter as including "any person who has purchased securities from an issuer with a “view” towards the “distribution” of the securities”". Therefore, GFL Ultra could not use section 4(1) in order to gain any form of exemption.

The GFL Ultra case also reiterated earlier SEC comments in the Problematic Practices Release that such trading was unacceptable. The SEC observed that “a trading pattern of short selling in the United States in connection with purchasing a Regulation S offering, which essentially locks in a profit ... runs counter to the goals of Regulation S”.  

However the GFL Ultra case is also notable for the significant dissent that the former SEC Commissioner, Steve Wallman made. He was of the opinion that at the time that the Fund’s transactions took place, there was too much confusion as to the Commission’s position on the hedging of securities (such as short term sales) under Regulation S, especially given the fact that at the time of the issuance of the Problematic Practices Release, the Fund had already stopped the hedging practices. Therefore, in his opinion, he felt that such retroactive, “after the fact” enforcement was not appropriate.

However in spite of the GFL Ultra case, the question still remained as to whether individuals could also be liable for hedging or short selling securities which came under Regulation S, as the case did not deal directly with this issue.

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97 The term “person” is defined in section 2(a)(2) of the Securities Act as including “a corporation”. The SEC found that the shares here were “distributed” because a substantial number flowed into the U.S trading markets and came to rest in the hands of the investing public. See n. 12


99 Id.
In summary, while it is not clear whether or not the SEC intended to make hedging illegal, it is clear that the Commission did not like this use of Regulation S. Thus, this case serves as a warning to Regulation S offering participants that hedging transactions have been identified as being inconsistent with the policies underlying the Securities Act and may in fact represent a basis for enforcement actions.100

Marketplace Concerns About Regulation S

It would be incorrect to say that the numerous enforcement actions bought by the SEC against those who breached Regulation S were the only reason for bringing about a general dissatisfaction with the Regulation. Over time, there have also been a number of concerns arising in the market generally about the workings of Regulation S101. What follows below is a discussion of some of these concerns.

A. Discounted Shares Available Solely to Foreign Purchasers

In many cases, shares sold under Regulation S are sold to offshore buyers at a discount to those available in the market. Unregistered securities falling under Regulation S can be

100 For example see SEC v. Ari Parnes et al, Litigation Release No. 16877, Jan. 31, 2001. The SEC charged defendants with a fraudulent manipulation scheme. The defendants issued $3.6 million of convertible Immunogen debentures under Regulation S to five Panamanian companies with a post office box in Switzerland. However the debentures never left the United States as they were held by an attorney of one of the defendants in New York. By selling short 1.7 million of the shares, and through other market manipulative techniques, the defendants drove down Immunogen’s stock price. The defendants then converted the Regulation S debentures into common stock at a discount to the market price (which they had artificially depressed), and then used the stock to cover their short positions. By doing so they illegally distributed the securities in the U.S. and produced millions of dollars of illegal profits.

sold for any price to foreign investors. This discounting usually comes about because Regulation S shares cannot be issued to U.S. investors.

Discounts are justified by promoters and issuers because of the restricted period in which the foreign investors have to wait with their securities before they can do anything with them, and the ensuing risk which the foreign investors must bear while waiting. In other cases, discounting occurs when a company is unable to raise funds without reducing their share price in order to become attractive to offshore investors. While it is acknowledged that some discounts may be justified, especially given the risks that foreign investors have to run, many domestic U.S. investors have formed the opinion that such discounts are not only unfair, but advantageous to foreign investors at their own expense.

In some cases, Regulation S shares were sold for up to 50% less than the market price – meaning that the market price would have to virtually collapse within the 40 day restricted period before the offshore investor would lose money on the transaction.

B. Lack of Disclosure

Up until the latter stages of 1996, the SEC did not require disclosure of Regulation S offerings. This meant that until this time, domestic investors were largely unaware of

102 The SEC has recognized that "some discounts may well be warranted in order to compensate for the length of the restricted period, historic volatility of the stock, financial condition of the issuer, the dilution represented by the newly issued shares, current market condition, availability of current information as to the issuer, information the issuer may have had that was disclosed to the purchaser but not otherwise disclosed to the market, or other factors." Problematic Practices Release, supra 77 at n.14

103 Scholl, supra note 73

104 Id.
many Regulation S offerings. The 1996 release required reporting issuers to report offerings within 15 days of their occurrence.\textsuperscript{106} However even today when non reporting issuers are involved, it will not be apparent when a Regulation S transaction has taken place. There will merely be an unexplained increase in the company’s shares outstanding. In many cases, because of the domestic investors’ lack of knowledge, they sustain losses due to an unexpected decline in the share value. The share value declines in these situations when the foreign investors sell their shares in the US market at the end of the restricted period, unbeknown to domestic investors, thus increasing the amount of shares available in the marketplace. Occasionally knowledge leaks out of a Regulation S transaction having taken place,\textsuperscript{107} and this too has the effect of reducing the share price in the market.

\textbf{C. Dilutive Effects as a result of the Flow of Regulation S Securities Back into the US Market}

Tied in closely with a lack of knowledge of a Regulation S offering having taken place is the dilutive effect associated with the flow of Regulation S shares back into the US market. The share price decline can best be explained by simple supply and demand analysis. For if an issuer increases its issued capital by issuing more shares, then this necessarily implies that the value of each existing share declines. With domestic issuers being unaware of the Regulation S offering, when the foreign purchaser comes out of the

\textsuperscript{106} \textit{Id.} at 88,701
restricted period and then chooses to sell the shares on the US market. The increased supply of shares usually leads to a drop in share price. This all occurs before the domestic investor has had a chance to find out about it.

107 Scholl, supra note 73
CHAPTER FIVE

Events Leading up to the Amendment of Regulation S

Given the combination of discounting, the lack of disclosure and the dilutive effects, coupled with the abuses that took place, it is possible to see how Regulation S could be used in a manner detrimental to the interests of the investors it was set up to protect while at the same time creating unintended opportunities for astute offshore investors.

Furthermore, Regulation S helped subvert the general principles underlying the U.S. securities regime. What follows below is an examination of the events and criticisms that lead to the recent amendments to Regulation S.

Developing Criticism of the Regulation

Starting in 1994 with media coverage and SEC murmurings of displeasure with the way Regulation S was headed, Edward Markey, Chair of the House Energy and Commerce Telecommunications and Finance subcommittee wrote to the SEC in April of that year requesting they report to Congress regarding the repeal or modification of Regulation S.110

108 Scholl, supra note 73. This is one such example of media commentary concerning the operation of Regulation S.
109 SEC’s Walter Highlights Concern over Application of Regulation S, 26 SEC. REG & L. REP. (BNA) 366 (Mar. 11, 1994).
110 Markey Seeks Report on Regulation S, 26 SEC. REG. & L. REP (BNA) 636 (Apr 29, 1997)
In a response to Markey, SEC Chairman, Arthur Levitt did verify that the SEC was conscious of the abuses, and that the SEC’s review could see the updating of the regulation to take account of the abuses or increase its enforcement provisions against such abuses.

**Problematic Practices Release**

In its release referred to as “Problematic Practices under Regulation S” the SEC outlined its assessment of violations of Regulation S. In particular, the release concentrated on Preliminary Note 2 of the original Regulation S stating that the regulation was not available “with respect to any transaction or series of transactions that, although in technical compliance [with the regulation] was part of a plan or scheme to evade the registration provisions of the Act”.

Thus in the report, the SEC noted that there were cases in which securities were being placed overseas in order to escape the registration requirements, and commented that such dealings were contrary to Preliminary Note 2. The report listed the use of bogus offshore shell companies, the improper use of promissory notes, hedging of Regulation S securities purchased at a discounted rate and the “washing off” of restrictions as transactions which breached Regulation S.

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113 Original Regulation S, *supra* note 1, at Preliminary Note 2
In issuing its release, the SEC also sought input on how to deal with such problems. It sought suggestions relating to a possible extension of the 40 day period to a one year period, and whether category three restrictions should be placed on category two securities. Also requiring comment was whether or not there should be some limit imposed on the amount of discounting available to securities coming under Regulation S. Finally discussion was encouraged regarding restrictions on hedging and the use of promissory notes.\(^{115}\)

**Fifteen Day Reporting Requirement for Regulation S Offerings**

In response to the lack of disclosure requirements under Regulation S, the SEC in October 1996 brought into effect amendments to the reporting forms of the Exchange Act, by requiring domestic, reporting issuers to disclose any offerings made under Regulation S.\(^{116}\) The effect of this was that all offerings made by domestic reporting issuers coming within Regulation S had to be disclosed on a form known as Form 8-K.\(^{117}\) This had to be undertaken within 15 days of the offering having taken place.

**Proposed Amendments to Regulation S**

After receiving submissions, the SEC published its proposed amendments to Regulation S in February of 1997.\(^{118}\) Here, the Commission advocated extending the restricted period

\(^{115}\) Id. at 35,665

\(^{116}\) Periodic Reporting of Unregistered Equity Sales, *supra* note 105, at 2763

\(^{117}\) Id. at 2764

for two years for domestic issuers and also for foreign issuers who had a principal market in the U.S.\(^{119}\) The rationale behind the extended two year period was to adjust the restricted period to coincide with the restricted period under Rule 144\(^{120}\). Also in this proposed amendments release, the SEC suggested extending the stricter category three requirements to all equity securities of domestic issuers and foreign issuers with a principal market for their securities in the U.S.\(^{121}\)

In order to achieve this, the SEC intended that a new section be added to Regulation S to reclassify such securities\(^{122}\) to come within Rule 144.\(^{123}\) The Commission also intended to prohibit promissory notes being used as a method of payment for Regulation S securities, and further, that purchasers of Regulation S securities would have to agree not to participate in any hedging of such securities.\(^{124}\)

Responses to the new measures proposed were varied.\(^{125}\) While the SEC believed the measure would put a halt to the abuses, others formed the opinion that the measures had gone too far to the other extreme and would be too restrictive for issuers attempting to raise capital via Regulation S.\(^{126}\)

\(^{119}\) Id. at 9260

\(^{120}\) 17 C.F.R. s 230.144 (1996)

\(^{121}\) Proposed Amendments Release supra note 118, at 9260-9262

\(^{122}\) i.e. equity securities of domestic issuers and foreign issuers with a principal market for their securities in the U.S.

\(^{123}\) Proposed Amendments Release, supra note 118, at 9263

\(^{124}\) Id. at 9262-9263, 9265

\(^{125}\) See as examples the letter from AIMR (Association for Investment Management and Research) http://www.aimr.org/professionalism/advocacy/97/commitr/offshore/html and J McLaughlin’s letter http://204.192.28.3/rules/proposed/s7897/mclaugh1.htm

\(^{126}\) Id., with particular reference to the McLaughlin letter.
CHAPTER SIX

Amendments to Regulation S

Actual amendments to Regulation S were adopted by the SEC on 10 February 1998, and came into force on 27 April 1998.\textsuperscript{127} When issuing the amendments, the SEC observed that they were "designed to stop the abusive practices in connection with the offerings of equity securities purportedly made in reliance on Regulation S".\textsuperscript{128} The release also noted that the area subject to most violation concerned the equity securities of domestic issuers.\textsuperscript{129} Therefore, it is not surprising that there have been significant changes to Regulation S concerning this area.

Domestic reporting equity securities were reclassified under the amendment to fall under the third issuer safe harbor.\textsuperscript{130} A new rule which classifies equity securities of both reporting and nonreporting domestic issuers as restricted securities under Rule 144\textsuperscript{131} was also added.

\textsuperscript{128} Amending Release, \textit{supra} note 28, at 9632.
\textsuperscript{129} \textit{Id.} at 9632 - 9633
\textsuperscript{130} Amended Regulation S, \textit{supra} note 124, at s230.903(b)(3), and Amending Release, \textit{supra} note 28, at 9634 – 9633.
\textsuperscript{131} \textit{Id.} at s230.905 and 9636 respectively
However foreign issuers with a principal market for their securities in the US did not have any further restriction imposed upon them – the reason being the lack of abuse in this area.\textsuperscript{132}

**General Statement is Not affected by the Amendments**

The general statement, as under Rule 901, did not undergo any amendments, in that it continued to state that offers and sales of securities that take place outside of the U.S. and that satisfy Regulation S will continue to be exempted from the registration requirements of section 5 of the Securities Act.\textsuperscript{133}

**Amendments to the Issuer and Resale Safe Harbors**

Generally speaking, the amendments changed the classifications of the securities that came under the different safe harbor categories.

**A. Amendments to the Two General Conditions of an Offshore Transaction and No Directed Selling Efforts in the United States**

The two general conditions remain for both issuer and resale safe harbors.\textsuperscript{134} Definitional changes are the main differences between the original Regulation S and the amended version. The category of “designated offshore markets” has been expanded to include

\textsuperscript{132} Amending Release, supra note 28, at 9633 and Proposed Amendments Release, supra note 118, at 9260 –9263.

\textsuperscript{133} Amended Regulation S, supra note 127, at s 230.901.

\textsuperscript{134} Id. at ss 230.903 (a)(1)–(2), 230.904 (a)(1)-(2)
markets that had been designated after the adoption of the original Regulation S.\textsuperscript{135} The definitions of “directed selling efforts” have been changed within the Regulation so as to make them more succinct, although directed selling efforts still embrace any efforts which prepare the U.S market for the offering and selling of securities through Regulation S.\textsuperscript{136}

\textbf{B. Amendments to the Issuer Safe Harbor}

The main change with respect to the issuer safe harbor was to equity securities of domestic reporting issuers. Such securities were moved into the third issuer safe harbor\textsuperscript{137} while the same type of securities of foreign issuers remained in the second category. There were also some slight definitional changes.\textsuperscript{138}

\textit{i. Changes to Category One}

The first issuer safe harbor continues to apply to the securities of offshore issuers who do not have a substantial U.S. market interest for their securities.\textsuperscript{139} to securities sold in “overseas directed offerings”\textsuperscript{140} securities backed by a foreign government\textsuperscript{141} and foreign

\textsuperscript{135} \textit{Id. at s} 230.902(b)
\textsuperscript{136} \textit{Id. at s} 230.902(c)
\textsuperscript{137} \textit{Id. at s} 230.903(b)(2)-(3)
\textsuperscript{138} Amending Release, \textit{supra} note 28, at 9638
\textsuperscript{139} Amended Regulation S, \textit{supra} note 127, at s 230.903(b)(1)(i)
\textsuperscript{140} \textit{Id. at s} 230.903(b)(1)(ii)
\textsuperscript{141} \textit{Id. at s} 230.903(b)(1)(iii)
employee benefit plans. All that securities falling into this category have to satisfy are the two general conditions of Regulation S.\textsuperscript{143}

There have been no changes to the definitions of category one securities. However, equity securities of domestic issuers falling under category one that have been sold to foreign employees according to employee benefit plans controlled by foreign law have now been reclassified to be restricted securities and instead fall under Rule 144. As a result of this, such securities are now under the limitations of a one year restricted period before being able to be resold into the U.S.,\textsuperscript{144} as opposed to in the past when they had no such restrictions other than the general category one requirements imposed on them.

\textit{ii. Changes to Category Two}

Securities coming within category two have changed significantly from the original Regulation S. Equity securities of domestic reporting issuers are no longer in this category – having been moved to category three instead\textsuperscript{145}, while securities of foreign reporting issuers having a substantial market interest for their issuings in the U.S., debt securities of reporting domestic and foreign nonreporting issuers are included in the amended category two.\textsuperscript{146}

\begin{itemize}
\item \textit{Amended Regulation S, supra note 127, at s 230.903(b)(2)-(3) and compare with Adopting Release, supra note 8 at s 230.903(c)(2)}
\end{itemize}

\begin{itemize}
\item \textit{Id. at s 230.903(b)(1)}
\item \textit{Id. at s 230.903(b)(1)(iv)}
\item \textit{Id. at s 230.903. Amending Release, supra note 28, at 9634}
\item \textit{Amended Regulation S, supra note 127, at s 230.903(b)(2)}
\end{itemize}
For those securities which are under category two, the two general conditions must still be satisfied (that there is an offshore transaction and that there are no directed selling efforts in the U.S.).\textsuperscript{147} Category two securities must also satisfy the transactional requirements – namely a 40 day restricted period where the securities cannot be sold to or for the benefit of a U.S. person.\textsuperscript{148} Distributors selling to securities professionals during this period still need to provide the purchaser with notice that they too are subject to the same restrictions as the distributor.

One definitional aspect worth noting is that the term "restricted period" as it was referred to in the original Regulation S is now known as the "distribution compliance period". The actual definition remains as it always was – instead the term used to identify it has been changed so as to avoid any confusion between the terms "restricted period" and "restricted securities". The offering restrictions of category two, however, have remained the same.\textsuperscript{149}

\textit{iii. Changes to Category Three}

While category three is still pertinent to all equity and debt falling within the earlier categories, it now also includes the equity securities of domestic reporting issuers.

\textsuperscript{147} Id. at s 230.903(a)
\textsuperscript{148} Id. at s 230.903(b)(2)(ii)
\textsuperscript{149} Id. at ss 230.902(g), 230.903(b)(2)(i). This means that distributors still must agree in writing that both offers and sales made before the end of the distribution compliance period will fall under Regulation S and that all offering materials used regarding the sale of Regulation S securities in the distribution compliance period also have to contain statements to the effect that the securities have not been registered and cannot be sold in the U.S. or to U.S. persons unless they have been registered first or granted an exemption.
domestic nonreporting issuers and foreign nonreporting issuers who have a substantial market interest in the U.S. for their securities.\textsuperscript{150}

Because of the higher probability that category three securities will flow back into the U.S., the procedures surrounding such securities are more demanding than those for the earlier two categories.\textsuperscript{151} Category three securities must not only satisfy the two general conditions but they are also subjected to a series of rigorous transactional and offering restrictions that have been changed since the original Regulation S.\textsuperscript{152}

The transactional restrictions make a distinction between debt and equity securities.\textsuperscript{153} The restrictions for debt securities remain the same as they were under the original Regulation S,\textsuperscript{154} and they continue to have a 40 day distribution compliance period.\textsuperscript{155} Debt securities also have to satisfy this 40 day restriction.\textsuperscript{156}

The transactional restrictions as applied to category three securities are more stringent under the amended Regulation S. Equity securities falling under category three must still satisfy a one year distribution compliance period.\textsuperscript{157} During this time, purchasers who are not distributors must certify that they are not U.S. residents or citizens and that they are not obtaining the securities for the benefit of a U.S. person.\textsuperscript{158} They must also agree that if the securities in question are to be resold, then any such resale must fall within the requirements of Regulation S, be registered or fall within

\begin{footnotes}
\footnotetext[150]{Amended Regulation S, \textit{supra} note 127, at s 230.903(b)(3)\textsuperscript{\textsuperscript{1}}}
\footnotetext[151]{Amending Release, \textit{supra} note 28, at 9635\textsuperscript{\textsuperscript{1}}}
\footnotetext[152]{Amended Regulation S, \textit{supra} note 127, at s 230.902(g), 230.903(b)(3)\textsuperscript{\textsuperscript{1}}}
\footnotetext[153]{\textit{Id.} at s 230.903(b)(3)(ii)-(iii)\textsuperscript{\textsuperscript{1}}}
\footnotetext[154]{\textit{Id.} at s 230.903(b)(3)(ii). See also Adopting Release, \textit{supra} note 9, at s 230.903(c)(3)\textsuperscript{\textsuperscript{1}}}
\footnotetext[155]{Amended Regulation S, \textit{supra} note 127, at s 230.903(b)(3)(ii)(A)\textsuperscript{\textsuperscript{1}}}
\footnotetext[156]{\textit{Id.} at s 230.903(b)(3)(ii)(A) and s 230.903(b)(3)(ii)(B)\textsuperscript{\textsuperscript{1}}}
\footnotetext[157]{\textit{Id.} at s 230.903(b)(3)(iii)(A)\textsuperscript{\textsuperscript{1}}}
\end{footnotes}
another exemption to the Securities Act requirements.\textsuperscript{159} Purchasers also have to agree to not partake in any transactions involving hedging of the Regulation S securities, unless such hedging is “in compliance with the Act”.\textsuperscript{160}

Category three transactional requirements also require that there be an inscription on the securities of domestic issuers providing that transfers of such securities are prohibited, unless the transfer is in accordance with Régulation S.\textsuperscript{161} The inscription must also state that hedging with such securities must not take place “unless in compliance with the Act”.\textsuperscript{162} The issuer too is legally bound\textsuperscript{163} to refuse to register any transfer that does not comply with Regulation S.\textsuperscript{164} Finally, distributors selling securities under category three must still provide notice to purchasers that the purchaser is subject to the same restrictions as the seller was.\textsuperscript{165}

The amendments to category three essentially strengthened the transactional requirements by requiring a statement to the effect of prohibiting hedging activities during the distribution compliance period unless they are in line with the Act itself.\textsuperscript{166} Such a position is consistent with the Commission’s earlier statements in both the Problematic Practices Release\textsuperscript{167} and in the \textit{GFL Ultra} case.\textsuperscript{168}

\footnotesize
\begin{itemize}
\item[158] \textit{Id.} at s 230.903(b)(3)(iii)(B)(1)
\item[159] \textit{Id.} at s 230.903(b)(3)(iii)(B)(2)
\item[160] \textit{Id.}
\item[161] \textit{Id.} at s 230.903(b)(3)(iii)(B)(3)
\item[162] \textit{Id.}
\item[163] Either by contract, provision in its bylaws or some other comparable document.
\item[164] Amended Regulation S, \textit{supra} note 127, at s 230.903(b)(3)(iii)(B)(4)
\item[165] \textit{Id.} at s 230.903(b)(3)(iv)
\item[166] \textit{Id.} at s 230.903(b)(3)(iii)(B)(2)-(3)
\item[167] Problematic Practices Release, \textit{supra} note 70
\item[168] In the Matter of GFL Ultra Fund Ltd., Administrative Proceeding Release No. 3-9333, 64 SEC Docket 1958 (June 18, 1997)
\end{itemize}
The amendments to Regulation S also made changes to the offering restrictions relating to category three domestic equity securities. Distributors have to agree in writing that all offers and sales made before the end of the distribution compliance period must comply with the Regulation. Distributors are now also required to provide in writing that they will not undertake hedging transactions with equity securities of domestic issuers unless it is in compliance with the Act. As with the original version, all documents and materials relating to the offer and sale of any category three securities are required to contain statements to the effect that the securities have not been registered and that they may not be offered or sold within the U.S. or to U.S. persons. Offering materials of equity securities of domestic issuers must also state that hedging is prohibited with respect to those securities, unless in accordance with the Act.

C. Changes to the Resale Safe Harbor and New Rule 905

While there were few changes to the resale safe harbor, Rule 905 was introduced so as to classify domestic equity securities as restricted securities within Rule 144.

i. Changes to the Resale Safe Harbor

Rule 904 under the Amended Regulation S still provides a safe harbor for the offshore resale of unregistered securities by any person apart from the issuer, distributor or their

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169 Amended Regulation S, supra note 127, at s 230.903(g)(1)(i)
170 Id. at s 230.902(g)(1)(ii)
171 Id. at s 230.902(g)(2)
172 Id. at s 230.905
agents and affiliates.\textsuperscript{173} The general conditions (namely of an offshore transaction and no directed selling efforts in the US) still remain. However there have been new conditions which at times apply to dealers and their affiliates.\textsuperscript{174}

\textit{ii. New Rule 905}

Termed “Resale Limitations”, the new Rule 905 gives domestic equity securities a restricted classification, and also it forbids using the resale safe harbor as a way of “washing off” restrictions from these securities. Rule 905 also tries to prevent the misuse of promissory notes with respect to Regulation S securities through Rule 144.\textsuperscript{175}

1.1 Domestic Equity Securities are now Classified Securities Within the Meaning of Rule 144\textsuperscript{176}

Under the amendments to Regulation S, Rule 905 was introduced and Rule 144 was modified so as to categorize domestic equity securities from both reporting and non-reporting entities as restricted securities.\textsuperscript{177} Rule 905 states that such domestic equity securities acquired in an offer or a sale that is subjected to Regulation S requirements will be considered restricted securities, and thus will fall within Rule 144.\textsuperscript{178} Therefore, the equity securities of domestic issuers will be subject to all the requirements of Rule

\begin{footnotes}
\item[173] Id. at s 230.904(a)
\item[174] Id. at s 230.904(a)(1)-(3)
\item[175] Id. at s 230.905
\item[176] 17 C.F.R s 230.144 (1997)
\item[177] Amending Release, supra note 28, at 9636, and Amended Regulation S, supra note 127, at s 230.905
\item[178] Amended Regulation S, supra note 127, at s 230.905
\end{footnotes}
144, including the one year holding period before such securities are able to be "onsold".  

1.2 Resales of Domestic Equity Securities not Eliminating the Restricted Securities Classifications

Rule 905 stops investors from washing off restrictions by the means of the resale safe harbor by providing that restricted securities defined under Rule 144 "will continue to be deemed to be restricted securities notwithstanding that they were acquired in a resale transaction" by means of the resale safe harbor.  

1.3 The Effect of Rule 905 on Promissory Notes

As a result of classifying domestic equity securities as being restricted securities under Rule 144, the use of promissory notes has been forbidden for purchasing Regulation S securities in cases where repayment for promissory notes came about by the resale of the Regulation S securities into the U.S. With Rule 144 now being applicable to domestic equity securities, the one year restricted period is tolled until particular conditions are met.  

In particular the one year restricted period under Rule 144 for purchasers will not begin unless the promissory note "provides full recourse against the purchaser of the securities;" and "is secured by collateral, other than the securities purchased, having a

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179 17 C.F.R. s 230.144(d)(1)(1997)
180 Amended Regulation S, supra note 127, at s 230.905
181 "Tolling" means that the holding period will not begin to run until the conditions are satisfied.
fair market value at least equal to the purchase price of the securities purchased.\textsuperscript{183} Another new addition to Regulation S is that even after the restricted period has been completed, before any resale of the security can take place, full payment for the promissory note must have occurred.\textsuperscript{184} As a result of this, offshore buyers cannot buy securities under Regulation S by promissory notes and then fund the payment of the notes from the proceeds of reselling the Regulation S securities into the U.S.

**Other Changes to the Amendments**

Other amendments to Regulation S saw the introduction of a quarterly reporting period for domestic issuers\textsuperscript{185} and made modifications regarding convertible securities.\textsuperscript{186}

**A. Reporting of Regulation S Transactions**

Because the distribution compliance period, or restricted period, was extended from 40 days to a year for domestic issuers, this meant that there was not much of a need for the sale of such securities to be reported within 15 days of any offering taking place. Thus it followed that the amendments to Regulation S removed the 15 day reporting requirement and instead made reporting necessary every quarter.\textsuperscript{187}

\textsuperscript{182} 17 C.F.R s 230.144(d)(2) (1997)
\textsuperscript{183} Id. at s 230.144(d)(2)(i)(ii)
\textsuperscript{184} Id. at s 230.144(d)(2)(iii). See also Amending Release, supra note 28, at 9637
\textsuperscript{185} Amending Release, supra note 28, at 9638
\textsuperscript{186} Id. at 9634.
B. Convertible Securities

Regulation S convertible debentures came about because they could be converted to common stock quickly and could be sold in the U.S. market almost immediately. This eliminated some of the risk of holding Regulation S common shares, which up until the amendment, were required to be held for a minimum of 40 days. Investors purchased convertible bonds in anticipation of receiving interest payments while waiting for the stock price to appreciate. When the stock price had increased above a specific price, the investors would then convert their bonds.188

Regulation S convertible debentures had a conversion price that was usually set by taking the average price of the securities for the five days leading up to the conversion date. Often, the issuer would also give an extra discount from the final conversion price so that the lower the price of the stock being purchased, the better the situation would be for the convertible debenture investors.

In many cases, share prices had a “mysterious habit of dipping”189 just prior to the debentures being converted. This not only resulted in suspicions arising about the use of convertible debentures with respect to Regulation S securities, but it also resulted in offshore debenture holders gaining significant bargains. Consequently, many companies refused to honor conversion rights on this form of convertible security.190 In dealing with these problems the SEC stated that the new restrictions and classifications

188 J Scholl Pirates Play, BARRON’S, Jan. 6, 1997
189 Id.
190 Id.
regarding domestic equity securities would also be applicable to convertible securities.\textsuperscript{191}

\textsuperscript{191} Amending Release, \textit{supra} note 28, at 9634
Probable Impacts of Amendments on Regulation S

It has been a little over two and a half years since the amendments to Regulation S came into effect. Therefore there has been little litigation regarding the new amendments and negligible evidence of the effects of the amendments. What follows are some assessments and predictions as to how the new amendments may address some of the issues raised throughout the thesis.

A. Probable Effect of the Amendments on the Cost of Raising Capital under Regulation S

Because of the increased compliance measures – such as certification, legending and record keeping, which all result in a cost of some form – it seems likely that the amendments would have the effect of increasing the cost of raising capital under Regulation S for domestic reporting issuers.

Also, extending the holding period for the equity securities of domestic reporting issuers will probably result in even greater discounts being given on such securities than before the amendments, with the discounts occurring as a result of those securities being labeled as restricted. The greater discounts would likely lead to
domestic reporting issuers selling even larger amounts of securities in order to raise the same amount of capital.

Therefore, because of these two factors, issuers may instead end up registering securities under the onerous Section 5 or seek other exemptions as opposed to satisfying the more strenuous requirements of the amended Regulation S.

However, it seems there should be little change financially for domestic nonreporting issuers and foreign issuers after the amendments to Regulation S, and these classes of issuer will probably continue to use Regulation S.

**Probable Impacts of Amendments on Regulatory Abuses**

While the abuses concerning the use of promissory notes and the use of the resale safe harbor to "wash" off restrictions have been dealt with explicitly by the amendments to Regulation S\textsuperscript{192}, other abuses have not been treated in the same manner.

For example, while hedging seems to be prohibited by changes to both the offering and transactional requirements of domestic issuers, there does not appear to be any definition within either the original regulation or the new amendments which defines the prohibition on hedging.

Further, the abuses concerning illegal resales within the restricted period (i.e. distribution compliance period) and the use of phoney offshore shell entities, while always illegal under the original regulation, have not been explicitly addressed.

\textsuperscript{192} See supra text accompanying note 166
Consequently such abuses can conceivably continue under the amendments. The only difference is that they may be more difficult to carry out.

A. *Illegal Resales Within the Distribution Compliance Period*

In the future, a problem may arise concerning the resale of Regulation S securities by offshore purchasers during the distribution compliance period. With it likely that issuers may offer greater discounts (given that there will be more restrictions on the securities in question), then there will be even greater motivation for purchasers to "onsell" the securities that they have purchased as soon as possible because they would gain from selling their discounted securities at the market price, without waiting out the distribution compliance period. Yet the increased safeguards in the amended regulation, especially with regard to domestic reporting issuers, make resale more difficult for the purchasers to carry out while still in the distribution compliance period. At the same time, the increased discounts could be viewed by offshore investors as providing some form of buffer so that purchasers will be less likely to suffer losses when they sell their securities, as the market would have to virtually collapse before the investors would suffer a loss.

Domestic reporting issuers also are required to register any transfer of securities that is not made in accordance with Regulation S.193 This means that such issuers have to be aware of the possibility that illegal resales may occur or that there may be attempts to wash off the restrictions in the resale transfer of the securities. It seems therefore that

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this new role imposed on issuers will make it more difficult for such illegal resales to take place.\textsuperscript{194} The SEC commented that this meant issuers now had “a monitoring role similar to that which is often imposed in connection with unregistered private placements”.\textsuperscript{195} Hopefully this monitoring role of issuers will prevent offshore investors from selling before the end of the distribution compliance period.

\textbf{B. Creation and Use of Fake Offshore Shell Entities}

With the distribution compliance period being extended to one year it is likely that this extended period would reduce some of the motivation for such sham entities being established with the sole intention of avoiding the provisions of Regulation S.

Category three requires that purchasers of such securities must certify that they are not U.S. persons and that they are not acquiring the securities for the account or the benefit of a U.S. person.\textsuperscript{196} The SEC believed that making such a requirement apply to equity securities of domestic reporting issuers would help to put an end to some of the abuses regarding phoney offshore shell entities.\textsuperscript{197} However, whether this requirement will serve as any deterrent measure to such practices remains unclear. Presumably those involved in the creation of such entities probably already knew the practice was against Regulation S. Consequently any additional notice requirements will probably not deter the users of such practices.\textsuperscript{198}

\textsuperscript{194} Amending Release, supra note 28, at 9636.
\textsuperscript{195} Id.
\textsuperscript{196} Amending Release, supra note 28, at 9636 and Amended Regulation S, supra note 127, at s 230.903(b)(3)(iii)(B)(1). See also Original Regulation S, supra note 1, at s230.903(c)(3)(iii)(B)(1)
\textsuperscript{197} Amending Release, supra note 28, at 9636.
\textsuperscript{198} Amended Regulation S, supra note 127, at s 230.902(k)(1)(viii).
Nonetheless, extending the distribution compliance period to one year would seem to act as a disincentive to those using the sham entities as a way of circumventing Regulation S. This is because of the greater risk associated with holding securities for a longer time frame.\(^{199}\) Also, in many cases, where offshore shells are used the share price is manipulated before dumping the shares back into the U.S. It would seem difficult to manipulate the share price for an entire year before reselling the shares back into the U.S. without being detected either by the SEC or the market itself.

C. Use of Promissory Notes

Under the amendments to Regulation S, the one year holding period for promissory notes relating to domestic securities is tolled, this means the notes have to be completely paid off before they are able to be resold in the U.S. Consequently schemes whereby the purchaser of a promissory note did not have to pay anything for the Regulation S securities before onselling them have been prohibited.\(^{200}\)

D. Use of the Resale Safe Harbor to "Wash Off" Restrictions from Otherwise Restricted Securities

By introducing Rule 905, the SEC has made it clear that the resale safe harbor can no longer be used as a means of washing off the restriction relating to equity securities of domestic issuers.\(^{201}\)

\(^{199}\) For example the market could fall, or the SEC could discover the phoney set up.
\(^{200}\) 17 C.F.R. s 230.144(d)(2) (1996)
\(^{201}\) Amended Regulation S, supra note 127, at s 230.905
E. Hedging

While the SEC put anti-hedging provisions in the Category three transactional and offering restrictions, it did not state what transactions were prohibited under Regulation S and what transactions were “in compliance with the Act”\(^\text{202}\). The SEC even stated in its release which accompanied the amendments that they did “not impose any new restrictions on hedging practices”.\(^\text{204}\) Thus, from this it would appear that the \textit{GFL Ultra Fund}\(^\text{205}\) and \textit{SEC v. Ari Parnes}\(^\text{206}\) cases contain the Commission’s view on hedging\(^\text{207}\). In \textit{GFL Ultra} it was found that the fund in question had purchased Regulation S shares with the intention of distributing them, therefore making the fund a statutory underwriter which needed to register its shares before it resold them\(^\text{208}\).

Yet with the new provisions in Category three in which purchasers of such securities agree not to become involved in hedging activities “unless in compliance with the Act”\(^\text{209}\), it is not clear whether purchasers not considered statutory underwriters would still be in breach of the regulation via the purchasing agreement.

Also unclear, because of extension of the restricted period from 40 days previously to one year under the amendments, is whether or not holding such securities (of


\(^{203}\) \textit{Id.}

\(^{204}\) Amending Release, \textit{supra} note 28, at 9635.

\(^{205}\) In the Matter of \textit{GFL Ultra Fund}, Administrative Proceedings Release, No. 3-9333, 64 SEC Docket 1958 (June 18, 1997)


\(^{207}\) \textit{See supra} Part IV.A.iv.

\(^{208}\) Administrative Proceeding Release, No. 3-9333, 64 SEC Docket 1958 at 1961 (June 18, 1997)

domestic reporting issuers) could still be regarded as purchasing the securities for the purposes of distribution.\textsuperscript{210}

**Probable Impact of Amendments on Marketplace Concerns**

As outlined earlier, the markets raised concerns about the operation of Regulation S\textsuperscript{211}. These concerns included discounting, a lack of disclosure and the dilutive effects of the Regulation S shares flowing back into the U.S market. These concerns are discussed below in light of the amendments.

**A. Greater Discounts Will Be Offered By Domestic Issuers**

It seems likely that because the holding period is extended for equity securities of reporting issuers to one year, such issuers will probably give even greater discounts than in the past. This is because of the greater risks that purchasers have to face, as well as the decreased transferability that such securities now face given the increased transactional restrictions.\textsuperscript{212} Furthermore, because domestic reporting and nonreporting issuers are subjected to the same restrictions, it seems likely that domestic nonreporting issuers will have to offer an even greater discount to prospective purchasers in order to attract them because nonreporting issuer securities are less tradable in the market than the securities of reporting issuers.

\textsuperscript{210} This is the definition of an underwriter in 15 U.C.S s 77b(11). See In the Matter of GFL Ultra Fund, Administrative Proceeding Release, No. 3-9333, 64 SEC Docket 1958 at 1960 (June 18, 1997).

\textsuperscript{211} See discussion infra Part IV.B

\textsuperscript{212} Amended Regulation S, supra note 127, at ss 230.903(b)(3)(ii)-(iv), 230.905. See also Rule 144 - s 230.144(a)(3)(v).
B. *Dilution May Become a Problem Depending on the Discounts Offered*

With greater discounts likely to be offered by offerors of domestic equity securities, purchasers may choose to wait out the period, given that the substantial discount would provide incentive to hold on to the securities for the entire length of the period. Then upon completion of the one year restricted period the offshore purchasers would probably create a huge wave of securities flowing back into the U.S market.\(^{213}\) As a result of this increase in the supply of securities on the market the price of the shares in question would probably reduce, thus creating an even greater dilution problem than in the past. In short, the dilutive effects will depend entirely on the attractiveness of the discount offered. Given the discussion below\(^{214}\) it would appear that issuers may not be able to discount as much as they may want to, without facing some repercussions from domestic issuers.

C. *Disclosure May Become a Problem*

Under the amendments, the SEC changed the reporting requirement from a fifteen day period to quarterly reporting.\(^{215}\) This change should result in sufficient disclosure for current shareholders about an issuer’s Regulation S offering before the dilutive effects of the offering are felt. It will also provide shareholders with a chance to query when these discounts are perceived as being too large, therefore preventing sales of shares under Regulation S at whatever price the issuer sees fit.

\(^{213}\) Proposed Amendments Release, *supra* note 118, at 9265

\(^{214}\) See *supra* Chapter 7.III.C.

However, should it become apparent to the market that a Regulation S offering has taken place, and if the market learns of this happening before the shareholders do, then short selling of the issuer’s stock may occur. This would result in a drop in the issuer’s share price occurring without the prior knowledge of the shareholders who could therefore not escape this reduction in share price.
CHAPTER EIGHT

Recommendations Should Abuses and Marketplace Concerns Regarding the Regulation Continue After the Amendments

As outlined above, there may still remain some opportunity for the abuse of Regulation S to take place in spite of the amendments. Discussed below are some suggestions which may help eliminate some of the abuses and concerns, should they continue after the amendment.216

A. Clarify the Law Regarding the Abuses and the Marketplace Concerns

i. The Need for Clarity

Previously, the SEC determined whether or not a certain transaction was a violation of Regulation S by interpreting Preliminary Note 2217. The SEC detailed what it perceived as violations of Regulation S in the Problematic Practices Release.218 However in some cases219 the transactions in question took place before the SEC had made its

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217 Adopting Release, supra note 9, at Preliminary Note 2 where it is stated that “in the view of the objective of these rules and the policies underlying the Act, Regulation S is not available with respect to any transaction or series of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act”.
218 Problematic Practices Release, supra note 77, at 35,663 – 35,664
219 For example In the Matter of GFL Ultra Fund, Administrative Proceeding Release, No. 3-9333, 64 SEC Docket 1958 (June 18, 1997).
interpretations that hedging and some uses of promissory notes were not permitted.\textsuperscript{220} In the amendments, however, the SEC failed to clarify its position with regard to its retroactive powers. This lack of clarity has meant that some Regulation S transactions have been structured in a relatively cautious manner. For example, many issuers’ category two securities have also complied with the category three requirements.

“Domestic issuers that sell equity securities under Regulation S already comply with the certification and legending requirements of Category 3 as a matter of common practice”\textsuperscript{221} in order to ensure that they meet the requirements of whatever the SEC charged them with, and to make them ‘safe’ from any retroactive application of the regulation.

This uncertainty does not help the operation of the Regulation. The SEC would be well advised to clarify the Regulation in terms of what exactly it considers to be a violation and to what extent, if any, it has retroactive powers, in order to create a greater degree of certainty in the operation of the Regulation.

\textsuperscript{220} See supra text accompanying note 100
\textsuperscript{221} Amending Release, supra note 28, at 9639
ii. **Ways of Clarifying the Regulation**

In order to clarify the regulation, the SEC could either state directly what it perceives as being abuses in the regulation or alternatively, it could rewrite the regulation relating it to the abuses of Regulation S that occur.\(^{222}\)

1.1. **Incorporate Rule 144 Promissory Note Provisions Directly Into Regulation S**

The current approach regarding Promissory Notes is to read Rule 144 in conjunction with Regulation S.\(^{223}\) Although these two rules overlap, they do not in any way directly address the promissory notes issue. What is needed is for the provisions contained in Rule 144 to be explicitly written in Regulation S. This could then make the Rule 144 provisions apply to the issuer safe harbors and relate the distribution compliance period to the holding period for the Rule 144 provisions. A measure like this would clarify the position and remove the necessity to read a separate regulation.

**B. Recommendations Concerning Promissory Notes if a More Clarified Regulation does not Work**

Should the SEC choose not to clarify its position with respect to promissory notes, or if such a clarified regulation did not work, then the SEC could consider the following.

\(^{222}\) Although an overstatement of what is considered an abuse could result in enabling the creation of further loopholes, care must always be taken to prevent this from occurring.

\(^{223}\) Amended Regulation S, *supra* note 127, at s 230.905 and see Rule 144 at s 230.144(d)(2).
i. **Toll the One Year Holding Period Until Promissory Notes are Fully Paid**

At present, the restricted period does not begin until the promissory note states that full recourse will be provided against the purchaser of the securities. Such recourse is to be secured by collateral that has a fair market value, and that is equal in value to the purchase price of the Regulation S securities. Following the expiration of the restricted period the promissory note is required to be fully paid for before the securities can be resold under Regulation S. Under the amendment this means that, conceivably, a purchaser could borrow in order to pay the note off in its entirety and then immediately resell the security, after which the loan could be repaid. This would mean that the purchaser would be paying for the promissory note with the funds acquired from the sale of the Regulation S securities – a transaction type which the amendment had tried to foreclose. Therefore, one way to stop this practice from occurring (essentially similar to that which happened before the amendment) would be to toll the distribution compliance period until the note has been paid for entirely.

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225 Id., and Amending Release, supra note 28, at 9637
ii. **Prohibit the Use of Promissory Notes Altogether as Payment for Regulation S Securities**

Should the problem with promissory notes continue, another more extreme measure would be to prohibit altogether the use of promissory notes as a means of payment for domestic equity securities. The SEC did in fact propose such an alternative with its initial amendments, although it did not mature into an actual amendment because of commentators’ concerns.

C. **Place More Clarifying Language in the Regulation Stating that the Resale Safe Harbor Cannot be Used to “Wash Off” Restrictions**

Reading Rule 905 and Rule 144 together, the resale safe harbor appears not to be available to “wash off” restrictions. It may be more appropriate, however, if the SEC were to amend Regulation S to clarify its position that the resale safe harbor is not to be used as a way of “washing off” restrictions as opposed to having to read the two rules together. Such a statement could be similar to that it issued in the Problematic Practices Release.

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227 Amended Regulation S, *supra* note 127, at s 230.905 which concerns resale limitations. It states that, “Equity securities of domestic issuers acquired from the issuer, a distributor, or any of their respective affiliates in a transaction subject to the conditions of s 230.901 or s 230.903 are deemed to be “restricted securities” as defined in s 230.144. Resales of any such restricted securities by the offshore purchaser must be made in accordance with this Regulation S.”
228 *See supra* note 77
D. Hedging Activities Prohibited Under the Regulation Need to be Clarified in the Regulation

Hedging continues to cause confusion because of the uncertain stance taken by the SEC. For example, in the GFL Ultra case²²⁹ the SEC stated that hedging was prohibited by Regulation S and anti-hedging measures were included in the amendments. Furthermore, section 230.902(g)(1)(ii)²³⁰ of the amendments states that “Each distributor agrees in writing … for offers and sales of equity securities of domestic issuers, not to engage in hedging transactions with regard to such securities (emphasis added)”, and likewise it is stated in s 230.902(g)(2)²³¹ that “[F]or offers and sales of equity securities of domestic issuers, such offering materials and documents also must state that hedging transactions involving those securities may not be conducted unless in compliance with the Act (emphasis added)”. A similar prohibition against hedging also appears in s 230.903(b)(3)(iii)(B)(2-3) of the amendments.

However the release accompanying the amendments stated that the changes did not place any new restrictions on hedging,²³² which seems to be at odds with the actual text of the amendment as outlined above. Therefore the SEC’s position with regard to hedging is ambiguous and needs to be clarified.

²²⁹ In the Matter of GFL Ultra Fund, Administrative Proceeding Release No. 3-9333, 64 SEC Docket 1958 at 1961 (June 18, 1997)
²³⁰ Amended Regulation S, supra note 127
²³¹ Id.
²³² Amending Release, supra note 28, at n. 28
Recommendations if the Amended Regulation Becomes too Restrictive for

Domestic Issuers in the Absence of Abuses

Given the tightening of the regulations pertaining to domestic issuers it is conceivable that Regulation S may no longer be used as a means of raising foreign capital by these issuers. The stricter regulations will make their offerings less attractive so that they may have to offer discounts, and their compliance costs will increase with the new notice requirements. The SEC itself noted that:

The amendments will impose restrictions on purchasers of equity securities of U.S issuers, as well as on the issuers themselves, that may make it more costly for such issuers to raise funds through Regulation S placements ... however, the Commission believes that these restrictions are needed to prevent abusive practices that have occurred under Regulation S.233

Given that a significant amount of disclosure is already required from domestic reporting issuers, by virtue of their own nature (as opposed to domestic nonreporting issuers), then it is debatable whether the two classes of issuers should be required to fulfil the same restrictions and regulations.

If the amended regulation becomes too restrictive, then the SEC could consider a number of different measures with respect to domestic reporting issuers, who are already subject to other disclosure mechanisms. For example, it could reduce the distribution compliance period to six months, and remove the restricted securities classification on such securities. The SEC could also consider putting such securities back into Category Two (as they were originally) or, alternatively, making the

233 Id. at Part V. Cost Benefit Analysis
transactional requirements similar to what they were in Category Two, as opposed to the more onerous requirements of Category Three.
CHAPTER NINE

The Challenges Posed by Globalization

As alluded to at the beginning of this thesis, the globalization of securities markets poses many challenges to regulators. These challenges include "the increasing integration of the world’s financial markets and the presence of systemic risk, referring to a simultaneous collapse of the securities markets worldwide". The debate over the regulation of global securities markets grows in importance as the internationalization of capital markets continues at a dramatic pace. There are varied approaches that regulators have adopted in response to this rapidly evolving international marketplace, several of which will be discussed below.

A. Extraterritoriality of the United States Securities Regime

The United States often applies its own domestic securities laws to transactions in other countries, justifying its actions as necessary to protect American investors and the integrity of U.S. capital markets. However, many commentators disagree with this extraterritorial approach stating that:

It is still in the best interests of the United States and of the global economy as a whole for disclosure regulation to be undertaken at the national level and for the

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234 See supra Part II.B
United States to apply its regime only to those issuers that have their economic center of gravity in the United States.\textsuperscript{236}

\textit{i. Section 5 and Regulation S}

Regulation S was adopted by the SEC in order “to clarify the extraterritorial application”\textsuperscript{237} of the section 5 registration provisions in the face of increasing globalization. It establishes a limitation to the possible world-wide jurisdictional reach of section 5\textsuperscript{238}. Rules 901 through 904, which form the body of Regulation S, take a primarily territorial approach to jurisdiction. Regulation S gives “recognition to the doctrine of comity and the territorial approach to the application of section 5”\textsuperscript{239}. While some commentators believe Regulation S to be ineffective in dealing with globalization\textsuperscript{240}, others believe that by limiting the application of U.S. laws and providing clear means for both investors and issuers to opt-out of the domestic regulatory system, it increases regulatory competition\textsuperscript{241} which, in turn, furthers the general goals of securities laws.\textsuperscript{242}

\begin{flushright}
\textsuperscript{236} CHOI \& GUZMAN, \textit{supra} note 6, at 903.  \\
\textsuperscript{237} Adopting Release, \textit{supra} note 9, at 18306  \\
\textsuperscript{238} See \textit{supra} Part II.C.  \\
\textsuperscript{239} Adopting Release, \textit{supra} note 9, at 18306  \\
\textsuperscript{240} “Most of the efforts made through regulation S and the extraterritorial application of the Securities Act to deal with the increasing internationalization of the securities markets have been misguided” CHOI \& GUZMAN, \textit{supra} note 6, at 914  \\
\textsuperscript{241} Jane C. Kang, \textit{The Regulation of Global Futures Markets: Is Harmonization Possible or Even Desirable?}, 17 J. INT’L. L. BUS. 242 (1996)  \\
\textsuperscript{242} See \textit{supra} text accompanying notes 267-68
\end{flushright}
ii. Justifications of Extraterritoriality

“Congress intended the Exchange Act to have extraterritorial application in order to protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from the effects of improper foreign transactions in American securities.”243, as confidence in a nation’s capital market may decline if fraudulent companies are allowed to issue securities in the market or traders are allowed to engage in manipulative practices. However the differing approaches detailed below are also argued to further the goals of securities regulation of investor and market protection.

Approaches to the International Regulation of Securities

Generally, most modern securities markets are regulated on a national basis. This practice creates a challenge in light of the increased internationalization of the securities markets and the increasing interdependence among them. Alternatives to extraterritorial application of national securities regimes as a means of regulating the international securities market are detailed below.

There are two key viewpoints which have developed in dealing with the challenges posed in regulating a global marketplace. Supporters of harmonization of securities regulation argue that standardization of regulatory requirements among countries would enhance protection for investors and level the playing field in the competition for market share. They argue that “regulatory disharmony remains a

243 Schoenbaum v. Firstbrook, 405 F.2d 200, 206 (4th Cir. 1968) (Judge Lumbard)
significant obstacle to the effectuation of an integrated international market". The opposing view is in favor of regulatory competition, which would provide choice to issuers and investors in how they should be regulated. Advocates of regulatory competition assert that harmonization could lead to excessive regulation without sufficient corresponding regulatory benefit. This belief is based on the many distinguishing characteristics of each nation’s market maturity, history, culture and legal system, which would make it very difficult to find a single solution which is viable for every country.

Various regulatory approaches have been taken in response to globalization, each intended to meet either the goal of harmonization or regulatory competition in a global marketplace.

A. Cooperation

In an increasingly global economy with complex offerings taking place in several jurisdictions, it may not be feasible for regulators in each country to attempt to enforce the perceived regulatory goals of that jurisdiction. In order to harmonize different regulatory approaches some nations are beginning to cooperate internationally both on a bilateral and multilateral basis in order to carry out their regulatory and enforcement objectives.

The aim of cooperation is the development of a common set of regulations to be used by all participants in international offerings. In order to encourage and

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244 STEINBERG & MICHAELS, supra note 235, at 208
implement cooperation in the international market, in 1974 several western nations\textsuperscript{247} organized what is today known as IOSCO\textsuperscript{248}. IOSCO’s primary objective today is to develop, on a global basis, high standards of financial market regulation, minimize systemic risk and facilitate cross border transactions\textsuperscript{249}.

Other commentators believe a better approach to the international regulation of securities would be one which encourages regulatory competition among different regimes and provides choice to issuers and investors in how they should be regulated. two of which are discussed below.

\textbf{B. Normal Reciprocity}

Under a normal reciprocity securities regime\textsuperscript{250}, a country allows a foreign issuer to sell securities within its domestic jurisdiction while complying only with the regulations of the issuer’s own jurisdiction. Normal reciprocity fosters capital mobility by increasing the regulatory choices to investors who are unable to sift capital abroad – so in this way it increases regulatory competition.

\textsuperscript{245} Sometimes referred to as commonality.
\textsuperscript{246} The benefits of cooperation are argued to include “the use of uniform information in making global investment decisions, the lowering of transaction costs, the facilitation of cross-border offerings, and the ability to establish an international database”. Manning G. Warren, \textit{Global Harmonization of Securities Laws: The Achievements of the European Communities}, 31 HARV. INT’L. L.J. 185, 191 (1990)
\textsuperscript{247} The charter members of IOSCO are Quebec and Ontario.
\textsuperscript{248} IOSCO was initially called the Inter American Association of Securities Commissions
\textsuperscript{249} STEINBERG \& MICHAELS, supra note 235, at n.213
\textsuperscript{250} As at July 1996, there were 465 agreements in place in 52 jurisdictions, IOSCO Index of Memorandum of Understanding and Similar Agreements Between IOSCO Members (July 1996)
\textsuperscript{250} Normal reciprocity can be found outside of the securities context. For example, many countries will honor the drivers licenses of other countries. Either the actual drivers license is accepted or individuals can obtain a visitor license by showing their foreign license without having to comply with local testing requirements.
Normal reciprocity is advantageous for issuers because it decreases the cost of selling securities abroad as parties are freed from having to learn and comply with a new set of laws when they enter a new jurisdiction. Rather, parties may continue to follow their own domestic laws regardless of the jurisdiction in which the transactions take place. Alternatively, if the issuer prefers the foreign jurisdiction’s regime, the issuer may choose to comply with its securities regulation instead.

The United States has a reciprocity agreement with Canada called the Multijurisdictional Disclosure System (MJDS,) which was established in 1991. Under this agreement Canadian issuers may issue securities in the U.S. while complying only with Canadian registration and disclosure requirements so long as their financial statements conform to U.S. generally accepted accounting principles. So Canadian issuers need not avoid American capital markets simply because they dislike the U.S. securities regulatory regime.

Normal reciprocity only allows an issuer to carry a domestic regime abroad as the issuer seeks capital in other countries. It does not allow a domestic firm to “import” another country’s laws. Consequently, some commentators\(^\text{251}\) believe that normal reciprocity does not maximize the potential for regulatory competition, and they support the portable reciprocity approach instead.

\(^{251}\) CHOI & GUZMAN, *supra* note 6, at 921
C. Portable Reciprocity

Under a portable reciprocity approach, participating countries would allow issuers to select the securities regime under which their securities transactions would be governed. Once selected, one set of securities laws would govern all aspects of the issuance and trading of the company’s securities, regardless of the physical location of the transactions.  

Portable reciprocity rejects territorial notions of jurisdiction and allows securities market participants to choose the most appropriate regulatory regime for themselves. In this way, portable reciprocity essentially allows issuers to determine the jurisdictional reach of different countries’ securities regimes.

“Portable reciprocity extends the concept of reciprocity to include multiple countries, diverse regulations, and greater issuer choice”. Any combination of issuer nationality, investor nationality, regime choice, and transaction location are permissible under a portable reciprocity regime. Therefore the choice of capital markets and the choice of governing law are completely separate.

Because issuers will choose the most efficient securities regime to govern their transaction, countries will have an incentive to provide such regimes in order to expand or maintain their capital markets. Therefore regulatory competition will increase. Also, “to the extent that extra regulatory protections are costly to issuers and not valued by

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252 For example, consider a U.S. based multinational firm named X. Co. Under a portable reciprocity regime X. Co. could choose to apply the laws of any participating country to a securities offering in the United States. The choice of regime is entirely up to X. Co. Furthermore, X. Co.’s transactions could take place within any of the participating countries.

253 CHOI & GUZMAN, supra note 6, at 921
sophisticated investors, global market efficiency is increased by allowing such issuers and investors to bypass these regulatory protections through their selection of an alternate securities regime".254

This thesis follows other commentators255 in asserting that portable reciprocity provides the best solution to the challenges of the international securities market.256 It is argued that portable reciprocity best advances the goals of securities laws, as regulatory competition among countries will benefit and protect both investors and capital markets.

Investors would benefit from a portable reciprocity approach as it increases the return on investment because it allows issuers to choose the regime with the least compliance costs. To the extent that issuers are forced to bear high compliance costs, issuers may either exit the capital markets or raise the price of their securities. Either action reduces the investor’s return on investment.

Another way in which portable reciprocity benefits investors is by increasing investor protection. It achieves this by introducing an additional factor for investors to consider when choosing an investment – the regime which the issuer chose to trade under. For example, investors may choose to restrict their investments to securities issued under U.S. laws. Because American securities laws are very strict, investors can assume that only high quality issuers seeking to distinguish themselves from lower quality issuers will choose to comply with the U.S. regime.

254 Dangerous Extraterritoriality, supra note 243, at 220.
255 CHOI & GUZMAN, supra note 6, at 950-51.
256 There are those who criticize portable reciprocity as creating investor confusion if investors fail to realize that securities trading in a particular capital market are in fact governed by another jurisdiction’s laws. Opposers of portable reciprocity also claim that the resulting regulatory competition may result in
Portable reciprocity provides capital market protection in at least two ways. First, it allows issuers and investors to avoid a country's overly burdensome regulatory regime while still trading in the capital markets of that country. Secondly, it increases investor confidence in the capital market to the extent that issuers select regimes which maximize the joint welfare of issuers and investors. This increases the securities volume and liquidity of a country's capital markets.257

For the above-mentioned reasons this thesis endorses portable reciprocity as the ideal approach for countries to adopt to the international regulation of securities.

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257 For example, investors may be adverse to trading in a small country's market due to its weak regulatory regime. However, under a portable reciprocity scheme an issuer can choose a stricter regime to govern the issuer's transactions in order to induce investors to trade in the small country's capital markets.
CHAPTER TEN

Conclusion

It is important not to forget why Regulation S was introduced when it was adopted in 1990. Essentially, the Regulation made it easier for domestic entities to raise capital offshore by reducing the costs involved and also by making domestic entities more attractive to offshore investors. The impetus for the introduction of Regulation S was the increasing globalization taking place, the uncertainty created as a result of the potentially worldwide reach of section 5 of the Securities Act 1933, and the ensuing Release No. 4708\(^{258}\) which resulted in “a voluminous series of no-action letters, which still left some continuing uncertainties”.\(^{259}\) However, after the introduction of Regulation S in 1990, many unintentional loopholes became apparent. These loopholes included illegal resales within the restricted period, the creation and use of fake offshore shell entities, the use of the proceeds of the Regulation S resales to pay for promissory notes, the use of the resale safe harbor to “wash off” restrictions, and the use of hedging to “lock in profits”. These loopholes were exploited by many investors and entities alike.

\(^{258}\) See supra note 17
\(^{259}\) RICHARD W. JENNINGS ET AL, SECURITIES REGULATION: CASES AND MATERIALS 577 (8th ed. 1998)
It was against this backdrop of abuse that marketplace concerns developed regarding the original Regulation.\textsuperscript{260} The marketplace became concerned about the discounting that was occurring on Regulation S securities because not only was such discounting only available to foreign investors, it was often not disclosed. This resulted in large yet unexplained flows of Regulation S securities entering the U.S market.

Initially the SEC acted to put a halt to both the abuses and the marketplace concerns by issuing the Problematic Practices Release\textsuperscript{261} in 1995. It was not until 1997, however, that the SEC issued its proposed amendments to Regulation S\textsuperscript{262}.

Following a discussion period in which comments were sought regarding the proposed amendment, the SEC adopted an amended Regulation S\textsuperscript{263} in 1998. While there was no change to the general statement, changes were made to both the issuer and resale safe harbors. The amendments also saw the addition of a new rule, Rule 905.

The SEC introduced the amendments in an effort to put a stop to the perceived exploitation and abuse of the original Regulation S. Yet in doing so, it would appear that these amendments have instead acted to curb some of the very objectives that the regulation was initially intended to promote.

A likely impact of the amendments is that, due to the additional compliance measures, the cost of raising capital under Regulation S will increase. Further, many of the abuses appear to be able to continue – albeit with more difficulty. While marketplace concerns relating to disclosure seem to have been addressed, concerns over

\begin{footnotes}
\item[260] See supra Part IV.B.
\item[261] See supra note 77
\item[262] Proposed Amendments Release, supra note 118.
\end{footnotes}
discounting have not been adequately dealt with, instead it appears that even greater
discounting and dilution could potentially occur under the amendments.

Given that the amendments generally do not seem to deal with the abuses and
concerns arising from the original Regulation S, it may be appropriate for the SEC to
consider various other measures in addressing Regulation S. Clarifying the powers that
the SEC possesses with respect to the regulation would help, especially as concerns
exist regarding the retroactive powers of the Commission. Further, clarification
regarding promissory notes, the use of the resale safe harbor to "wash off" restrictions,
and the use of hedging would be relatively simple measures the SEC could apply in
order to help the operation of the amendment.

Should it become evident following the amendments that the marketplace
concerns remain, then the SEC could consider improving the disclosure provisions
regarding Regulation S securities. This would presumably make shareholders aware of a
Regulation S offering and provide them with an opportunity to sell before the flow back
of shares into the U.S. market.

Another possibility following the amendments is that the regulation may become
too restrictive for domestic issuers. If this were found to be the case, then perhaps the
SEC should reduce some of the restrictions on this category of issuer.

Therefore, while Regulation S was introduced to provide greater certainty with
respect to offshore offerings, its actual application has developed in a manner nintended
by the SEC. While the SEC acknowledged this in its amendments, it is still not entirely

\[^{263}\text{Amending Release, supra note 28.}\]
evident whether the amendments have in fact been successful in achieving their aims. Perhaps instead what is required is greater clarity of the SEC’s position, while at the same time still creating a fair and workable securities regime. The recent globalization of capital markets will need to be taken into consideration in order to achieve this.

As the internationalization of securities markets continues, the importance of effective regulation for offshore transactions grows. There are several possible approaches to the regulation of international securities transactions: cooperation, normal reciprocity and portable reciprocity. However, because it best furthers the securities regulation goals of investor and market protection, portable reciprocity is recommended as the ideal approach for the United States (and other countries) to apply to the regulation of international capital markets.

264 See supra Part VIII.A.i.1.1.
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