INTERNATIONALIZATION OF THE SECURITIES MARKETS—MOVING AWAY FROM SECTION 5

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1. INTRODUCTION

While the internationalization of the securities markets has proceeded at an exponential rate,1 changes in regulation have not kept pace. The primary reason is that the Securities Act of 1933 (the “Securities Act”)2 was crafted with a domestic market in mind. The most troublesome problem encountered when attempting to adapt the domestic rules to an international market is the distinction made by the securities laws between primary distributions, which are regulated by Section 5 of the Securities Act,3 and secondary trades, which are exempt from registration under the Securities Act.4 When securities of an is-

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3 Section 5(a) of the Securities Act, 15 U.S.C. § 77e (1987), provides that, unless a registration statement is in effect as to a security, it is unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise or to carry or cause to be carried through the mails or in interstate commerce, by means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

4 Section 4(1) of the Securities Act, 15 U.S.C. § 77d(1) (1988), exempts from Section 5 transactions by any person other than an issuer, underwriter or dealer.
issuer are traded in U.S. markets, this distinction is rational because the Securities Act requires disclosure in connection with primary distributions, and the Securities Exchange Act of 1934 (the "Exchange Act") requires periodic reporting of information by most public companies. Information is therefore generally available to purchasers in both primary distributions and secondary markets. However, when securities of the issuer are traded only in foreign markets, while the Securities Act continues to apply to primary distributions made to U.S. persons, reporting of periodic information is not required by the Exchange Act. Thus, U.S. persons purchasing in foreign markets are not provided with the protection of U.S. securities laws.

It is not the lack of protection of U.S. investors in foreign secondary markets that causes the greatest concern, however. It is the application of the registration provisions of Section 5 in an international marketplace that creates confusion and often results in U.S. persons being excluded from investment opportunities. As a solution to this problem, some commentators have suggested the adoption of a "territorial approach" to the application of U.S. securities laws. A territorial approach would provide for application of Section 5 only when an offer or sale is made within the United States. The Securities and Exchange Commission (the "Commission") recently proposed a method for implementing the territorial approach (the "Commission's Proposal" or the "Proposal").

This article discusses the territorial approach and the Commission's Proposal. It explores the reasons why a further step is required

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Periodic reporting is required under the Exchange Act by (a) issuers of securities listed on a national securities exchange (15 U.S.C. § 781(b) (1988)), (b) issuers that are engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce, and have total assets in excess of $5,000,000 and a class of equity security (other than an exempted security) held of record by 750 persons (15 U.S.C. § 781(g) (1988) and 17 C.F.R. § 240.12g-1), and (c) issuers that have filed a registration statement that has become effective pursuant to the Securities Act (unless the duty to file is suspended because the class of securities to which the registration statement relates is held of record by fewer than 300 persons) (15 U.S.C. § 78o(d) (1988)).

7 If an U.S. registered offering was made, subsequent periodic reporting would be required pursuant to Section 15(d) of the Exchange Act. 15 U.S.C. § 78o(d) (1988).

8 See The Division of Market Regulation, Securities and Exchange Commission, Summary of Internationalization Roundtable on February 17, 1987 21 (Aug. 1, 1987) [hereinafter "Roundtable Summary"] (where it is recognized "that the Securities Act imposes some artificial impediments and costs on operation of the markets with minimal benefits").

9 L. Quinn, Redefining 'Public Offering or Distribution' for Today, Address to Federal Regulation of Securities Committee Annual Fall Meeting (Nov. 22, 1986). See also Roundtable Summary, supra note 8, at 3.

to integrate the Securities Act and the Exchange Act in both domestic and international markets and recommends placing greater emphasis on the Exchange Act reporting system for securities traded in the United States while moving away from the registration requirement of Section 5. Changes that have already taken place in domestic regulation through adoption of an integrated disclosure system provide guidance for a retreat from Section 5 in the international marketplace. Likewise, the ALI Federal Securities Code (the "ALI Code" or the "Code"), if it had been adopted, would have taken steps in this direction. A move toward increased reliance on Exchange Act reports would harmonize U.S. securities laws in the international marketplace and eliminate the anachronism of the "primary/secondary" distinction.

2. TREATMENT OF PRIMARY AND SECONDARY OFFERINGS UNDER U.S. SECURITIES LAWS

Section 5 of the Securities Act is designed to require registration of, and to provide information to the public about, new offerings, or "distributions" of securities. It applies to offers and sales by an issuer, a

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The integrated disclosure system was adopted by the Commission in 1982 to integrate the disclosure systems under the Securities Act and the Exchange Act. Securities Act Release No. 6383, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328 (March 3, 1982). One of the primary reasons a new system was implemented was to provide a method for companies that file reports under the Exchange Act to incorporate by reference documents filed under the Exchange Act into prospectuses to be used in connection with offerings registered under the Securities Act, thus saving time and money. Although Section 5 continues to apply to any offer or sale of securities in the absence of an exemption, a short-form registration may be used by issuers that have made filings under the Exchange Act for at least 36 months. Two types of short forms are available for such issuers. Those issuers that meet certain transactional tests may use a prospectus that provides information about the transaction, but incorporates by reference to Exchange Act filings information about the issuer, including financial information that has previously been filed and that may be filed in the future. The assumption with respect to such offerings is that information regularly published by those issuers under the Exchange Act is followed by participants in the marketplace, and this information accordingly need not be repeated in the prospectus. (See Form S-3, 17 C.F.R. § 239.13 (1988), and Form F-3, 17 C.F.R. § 239.33(1988)) Issuers who have been reporting for three years but do not meet the transactional tests also incorporate by reference previously filed Exchange Act reports, but must either deliver with the short-form prospectus their latest annual report to security holders or include additional information in the prospectus. (See Form S-2, 17 C.F.R. § 239.12 (1988), and Form S-3, supra).

12 FEDERAL SECURITIES CODE (Draft 1980) [hereinafter "ALI Code" or the "Code"). The ALI Code was a project to codify the federal securities law of the United States, intended to be enacted by Congress to replace existing securities laws. The Code would have provided a system of company registration, with continuous disclosure, as a substitute for multiple registration of securities. The Code was never adopted and is not now being actively considered.

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dealer or an underwriter, provided jurisdictional means are used and no exemption is available. Secondary trades (those made by a person other than an issuer, underwriter or dealer) are exempt from Section 5. Congress exempted secondary trades because the Securities Act is intended to address the problem of disclosure in connection with distributions as distinguished from trading. Registration of new distributions is required by the Securities Act because of the special selling efforts and additional sales pressure often present in primary offerings.

The Exchange Act governs disclosure of information about securities in secondary trading markets. It requires periodic disclosure by

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18 The term "underwriter" is defined in Section 2(11) of the Securities Act, 15 U.S.C. § 77b(11) (1988), as any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; [unless the interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission.]

As used in the definition, the term "issuer" includes "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer". Id.

14 Section 5 applies only if instrumentalities of interstate commerce are used. See supra note 3.


16 H.R. 85, 73d Cong., 1st Sess. 15 (1933).

17 See SECURITIES AND EXCHANGE COMMISSION, DISCLOSURE TO INVESTORS, A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS — "THE WHEAT REPORT," (March 1969) (from the Disclosure Policy Study) [hereinafter "Wheat Report"]). The Wheat Report states that a buyer of securities in an initial distribution is in a somewhat different position from the buyer in the trading markets. . . . [C]ompensation that dealers and salesmen receive when they participate in a '33 Act offering is almost always appreciably more generous than that customarily received in exchange or over-the-counter trading. New securities have to be distributed in short order. . . . For [this] reason, among others, quantitative differences between the new issue and trading markets must be regarded with caution. Nevertheless, in the Study's judgment, the statistics demonstrate the need to achieve a better balance in disclosure policy, with greater emphasis on continuing disclosures for the trading markets.

Wheat Report, at 60-61.

18 As noted in the Wheat Report

A classic statement of the purposes of provisions designed to inform the trading markets is found in the report of the House Committee on the '34 Act: 'No investor, no speculator can safely buy and sell securities . . . without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers or sellers as to the fair price of the security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial
issuers who have securities traded on a national (U.S.) exchange, by issuers who have used the jurisdictional means and meet certain minimum asset and shareholder tests, or by issuers who have previously made an offering registered under the Securities Act.¹⁹ Most foreign issuers with no U.S. trading market do not file periodic reports in the United States under the Exchange Act. Even if they meet the minimum asset and shareholder tests, they have not used jurisdictional means, or they claim exemption from registration under the Exchange Act pursuant to a rule that exempts foreign private issuers who have fewer than 300 U.S. shareholders or who furnish certain information to the Commission.²⁰

The system of securities regulation established by the Securities Act and the Exchange Act requires that information be available to purchasers of securities in both primary distributions (under the Securities Act) and secondary markets (under the Exchange Act) in the United States. In a foreign context, however, the result is that information is required to be provided by the Securities Act when offers or sales are made by an issuer, underwriter or dealer to U.S. persons,²¹ but the Exchange Act does not apply when U.S. persons purchase securities in foreign secondary markets.

Another major difference between regulation of primary distributions and secondary trades is the liability provisions of Section 11 of the Securities Act.²² Section 11 provides a remedy for any person acquiring a security registered under the Securities Act against any person signing the registration statement, directors, partners,²³ experts and underwriters if the registration statement contained an untrue statement of a

manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operations of the markets as indices of real value. There cannot be honest markets without honest publicity.’ H.R. 1383, 73d Cong., 2d Sess., p. 2 (1934).

Wheat Report, supra note 17, at 50.

¹⁹ Pursuant to Section 13(a) and 15(d) of the Exchange Act, 15 U.S.C. §§ 78m(a), 78o(d) (1988), issuers with securities registered under Section 12(b) or 12(g), 15 U.S.C. §§ 78l(b), 78l(g) (1988), and issuers that have filed a registration statement under the Securities Act must file annual and periodic reports with the Securities and Exchange Commission. See supra note 6.

²⁰ 17 C.F.R. § 240.12g3-2 (1988).

²¹ The Commission has taken the position that it will not take enforcement action if securities are sold abroad to non-U.S. persons without registration under circumstances reasonably designed to prevent the distribution or redistribution of the securities into the United States or to U.S. persons. Securities Act Release No. 4708, [1964 Transfer Binder] Fed. Sec. L. Rep., (CCH) ¶ 1361-63 (July 9, 1964).


²³ Persons who, with their consent, are named in the registration statement as being or about to become directors, persons performing similar functions or partners are also subject to liability. 15 U.S.C. § 77k(a)(3) (1988).
material fact or omitted to state a material fact required to be stated or necessary to make the statements not misleading (unless it is proved that the plaintiff knew of the untruth or omission).°" Purchasers in the secondary markets of securities not covered by the registration statement are not protected by Section 11, but rather must prove the elements of a claim under Rule 10b-5.° When securities are fungible, and purchasers in the secondary markets may be relying on the same information as those in the primary distribution in making their investment decisions, this distinction is of questionable fairness.

2.1 Problems Resulting From Primary/Secondary Distinction

In the international market, contrived practices and unusual problems have developed as a result of the primary/secondary distinction. Confusion arises daily about when a U.S. person can purchase securities in a foreign market following a distribution by an issuer in that market. If the securities were sold to a U.S. person as part of the distribution and jurisdictional means were used in the offering, the issuer may have violated Section 5. As a result of the concern that jurisdictional means may be used even when an offering is made solely to foreigners, restrictions are often included in offering documents to assure that securities are not sold to U.S. persons until they have "come-to-rest" abroad.° The come-to-rest concept is derived from the Com-

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24 Certain defenses are available to persons other than the issuer. 15 U.S.C. § 77 k(b)(3) (1988).
25 Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (1988). Rule 10b-5 provides,
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


mission's Securities Act Release No. 4708 ("Release 4708"), which states that the Commission will not take enforcement action if securities are sold to non-U.S. persons without registration under circumstances reasonably designed to prevent the distribution or redistribution of the securities into the United States or to U.S. persons. As a result of this position, issuers, including U.S. and foreign issuers with a U.S. market for their securities, may sell their securities abroad without registration if they take precautions designed to assure that the securities come-to-rest abroad.

A number of anomalies result from application of Section 5 and the come-to-rest concept. First, U.S. persons are often excluded from participating in offerings of securities by foreign issuers, even though they could purchase securities of the same class of the same issuer in a foreign secondary market.

Second, when there is a U.S. market for securities of the issuer, it is more likely that securities will return to the United States, and, accordingly, such issuers are required to take more precautions to assure their securities come to rest abroad than are issuers without a U.S. market. Thus, U.S. persons are precluded from buying securities of issuers with a U.S. market (for which there is information available as a result of reporting obligations under the Exchange Act) for a longer period of time than they are precluded from buying securities of issuers with no reporting obligation.

The problem is compounded when securities are traded in markets in both the United States and foreign countries and the markets are linked. If securities of an issuer are subject to a linkage, a broker in

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28 The staff of the Commission has not formally taken the position that an issuer with a U.S. market must take additional precautions. Informally, however, the staff has expressed the concern that it is more likely that securities for which there is a U.S. trading market will be resold in the United States. In a no-action letter to Cineplex Odeon Corporation, however, restrictions were placed on securities sold in a private placement abroad that prohibited sale in the United States or to a U.S. person for a period of one year following the placement. Following the one-year period, sales could be made freely on the Toronto Stock Exchange, even though the securities were listed on the New York Stock Exchange and could accordingly be easily resold in the United States. Cineplex Odeon Corporation, SEC No-Action Letter (March 19, 1987).

29 A linkage will work only with respect to issuers listed on both linked exchanges. A linkage is an order routing system pursuant to which quotations are displayed electronically to the linked exchange. If the price in that market is better, the order will be placed in that market in the same manner as any other order. See Report to Congress, supra note 1, at V-48, regarding established linkages. Under the Commis-
one market will place a quote that may be executed in the other market. Thus, even though an order may be placed in a foreign market, the actual trade may take place in the United States. An issuer with securities traded through a linkage that makes an offering in the foreign market would, under present law, be required to register the offering under the Securities Act.

An interesting technical problem raised by offerings made by foreign issuers with a U.S. market presents a further aspect of the confusion. The problem arises in connection with the practice, common in many foreign markets, for affiliates of an issuer to perform the liquidity function often performed in the United States by market makers. The technical Section 5 issue is whether an issuer with a U.S. market for its securities, whose affiliate acts as market maker in the foreign market, is required to maintain a registration statement to cover sales made by the affiliate through the foreign exchange in connection with those activities. The question is whether persons who purchase securities through the foreign exchange may be considered underwriters if the securities are resold in the United States or to U.S. persons because the securities may have been purchased from an affiliate. The need for consideration of such an issue illustrates the distorted problems that can arise when Section 5 is applied in an international context.

3. THE NEED FOR A TERRITORIAL APPROACH

There appears to be little disagreement that the structure of the securities laws needs to be reexamined in light of an international market. In November 1986, the director of the Division of Corporation Finance at the Commission suggested adoption of a "territorial approach" to address the problem of regulating an international securities market. Specifically, she suggested defining "a public offering or distribution subject to Section 5 registration obligations as an offering of securities executed on a U.S. exchange by means of [a] linkage Securities Act will be deemed to have been executed on a foreign securities exchange." See Securities Act Release 6779, FN 81.


securities to those persons who require the protections of [registration]... within the U.S. capital markets.” The Commission’s Proposal suggests a way to implement such a territorial approach by providing in a general statement the elements to be considered in determining whether an offer or sale is made outside the United States and creating “safe harbor” rules pursuant to which Section 5 is deemed inapplicable to “offshore transactions” that satisfy specified requirements.

The territorial approach is derived from principles used to determine when a court will exercise subject matter jurisdiction in cases arising under the securities laws. In general, jurisdiction will be exercised based on the existence of significant conduct or effects in the United States. These concepts have provided the basis for jurisdiction under international law and are set forth in the American Law Institute’s Restatement (Second) of Foreign Relations Law of the United States (the “Second Restatement”). Section 17 of the Second Restatement states that a government may regulate (and thus a court may apply its national law to) conduct occurring and matters located in its territory (the “conducts test”). Section 18 of the Second Restatement provides that a government may regulate conduct outside its territory that causes effects within the country where that conduct is generally recognized as illegal or where the effects were foreseeable and substantial and regulation by that government would be consonant with the law of other states (the “effects test”). The ALI’s Third Restatement of Foreign Relations Law includes the conducts and effects tests, but provides additional criteria for determining whether jurisdiction should be exercised. While these principles are generally applied under the

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52 Quinn, supra note 9, at 5.


A state has jurisdiction to prescribe a rule of law (a) attaching legal consequences to conduct that occurs within its territory, whether or not such consequences are determined by the effects of the conduct outside the territory, and (b) relating to a thing located, or a status or other interest localized, in its territory.

Section 18 provides

A state has jurisdiction to prescribe a rule of law attaching legal consequences to conduct that occurs outside its territory and causes an effect within its territory, if either (a) the conduct and its effect are generally recognized as constituent elements of a crime or tort under the law of states that have reasonably developed legal systems, or (b)(i) the conduct and its effect are constituent elements of activity to which the rule applies; (ii) the effect within the territory is substantial; (iii) it occurs as a direct and foreseeable result of the conduct outside the territory; and (iv) the rule is not inconsistent with the principles of justice generally recognized by states that have reasonably developed legal systems.

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securities laws only in fraud cases, the theory behind the proposal that U.S. registration provisions be applied only within the United States is similar to that of the conducts test.

The ALI Code's provisions\(^{35}\) regarding extraterritoriality as applied to a registration requirement were patterned after Section 17 of the Second Restatement. The Code would have used the conducts test of Section 17, applying the provisions of the Code to a sale or purchase of a security, an offer to sell or buy a security or an inducement not to buy or sell a security that occurs (in each case) within the United States although it is initiated outside the United States. The Code would not have applied, however, except in fraud cases, to offers or sales that occurred outside the United States although initiated within the United States. For this purpose, citizens of the United States would not have been protected by the registration provisions if offers and sales were made to them while they were abroad.

Numerous issues arise in an attempt to formulate rules to carry out the theory of the territorial approach, the most important of which is the potential for evasion of U.S. law. Without a come-to-rest standard, the Section 5 registration provisions may be evaded as securities are sold abroad and resold immediately into the United States. In addition, in an era of telecommunications, a person in the United States can readily place orders abroad. If U.S. regulation applies in all cases only to offers and sales within U.S. markets, and does not protect an order placed from the United States over the telephone in an overseas market, it may be convenient for issuers, both domestic and foreign, to avoid registering their securities while obtaining U.S. capital by making a distribution overseas. Presumably, the ALI Code would have applied to such transactions because the U.S. citizen was in the United States when the offer was made. The Code would not have protected the U.S. citizen buying the same securities in foreign secondary markets, however, and in that case the primary/secondary distinction under present law would have remained.

4. The Commission's Proposal

The Commission's Proposal provides that any offer or sale that occurs within the United States is subject to Section 5 and any offer or sale that occurs outside the United States is not. The Proposal contains a General Statement for determining whether an offer or sale occurs

\(^{35}\) ALI Code, supra note 12, § 1905(a)(1)(A).
within or outside the United States. Factors to be considered include the locus of the offer or sale, the absence of directed selling efforts in the United States, the likelihood of the securities coming to rest outside the United States, and the justified expectations of the parties to the transaction as to the applicability of U.S. securities laws. The Proposal also includes safe harbors for issuers to rely upon in making sales outside the United States and for resales of securities abroad. If all provisions of a safe harbor are satisfied, the offer and sale are deemed to have been made outside the United States.

To qualify for any safe harbor, an offer and sale must be made in an "offshore transaction," which requires that the buyer be offshore at the time the buy order is originated and that the transaction be consummated overseas, or that the sale not be prearranged by persons in the United States and be made on or through the facilities of an established foreign securities exchange. A second requirement is that there be no "directed selling effort" in the United States. In addition to these requirements, restrictions would be imposed, depending on the nature of the issuer. Securities of foreign issuers in which there is no substantial U.S. market interest could be offered and sold outside the United States without further restriction, however.

Securities of reporting issuers, foreign and domestic, would be subjected to transactional and offering restrictions. Transactional restrictions would require that any offer or sale during a 90-day restricted period not be made into the United States or to a U.S. person. The 90-day period would begin to run on the later of the closing of the offering or the date the first offer of securities to persons other than distributors is made. In the case of continuous offerings, it would run from completion of the distribution. When the 90-day period ended, the securities would be treated as unrestricted. The issuer would be required to ensure that any non-distributor to whom it sold securities was a non-U.S. person. Additionally, the deposit of securities into an American Depositary Receipt ("ADR") facility would be deemed a sale in the United States. Thus, the deposit side of an issuer's ADR facility would be required to be closed during the restricted period. Offering restrictions would be imposed on the issuer, distributors and their affiliates to as-

36 The term "directed selling efforts" would mean any activity, such as contacts with investors by telephone, written communication or investor meetings, for the purpose of inducing the purchase or sale of any of the securities being offered or sold in an offering made in reliance on Regulation S. Conducting a directed selling effort in the United States would result in the safe harbor not being available for the entire offering.

37 An ADR is a negotiable certificate, usually issued by a U.S. bank denominated in shares, certifying that a stated number of securities of a foreign private issuer have been deposited with a U.S. bank or its foreign affiliate or correspondent.
sure compliance with the prohibitions. These restrictions are more lenient than under Release 4708. Most importantly, "lock-up" procedures and restrictive legends would not be required.38

All other issuers would be required to comply with traditional restrictions to prevent flowback, including a 90-day period in which sales of debt securities, and a one-year period in which sales of equity securities, to U.S. persons would be prohibited. Traditional lock-up procedures would be required.39

The Proposal also contains a safe harbor for resales by persons other than issuers, distributors and their affiliates. Persons who held securities subject to restrictions imposed as a result of an unregistered offering abroad or any other securities that could not be resold freely in U.S. markets (including those received in a private placement or pursuant to an intrastate offering) could avail themselves of the resale safe harbor. Those persons could either (1) resell the securities in an offshore transaction with no directed selling efforts in the United States and without further offering restrictions other than that purchasers be notified of the transactional restrictions, or (2) with respect to securities of issuers other than non-reporting U.S. issuers and non-reporting foreign issuers with a substantial U.S. market interest, resell the securities through an established foreign securities exchange. In the case of reporting issuers only, the provision is limited to those cases where the seller was not aware that any counter party was a U.S. person.

4.1 The Commission's Proposal-Analysis Of Its Accomplishments

The Commission Proposal would solve many problems that have arisen under the come-to-rest standard of Release 4708 but, because of the constrictions of Section 5, it does not eliminate the artificial procedures required for sales of securities of reporting companies abroad.

4.1.1 Non-reporting Foreign Issuers

As the Commission has recognized, relief from Section 5 for non-reporting foreign issuers who have not deliberately accessed U.S. capit-

38 Offering restrictions require that (a) each distributor in privity of contract with the issuer, seller or any managing underwriter agree in writing that all offers and sales will be made in accordance with Regulation 5 or, unless registered or exempt from registration, (b) each distributor or dealer purchasing securities from a distributor receive a confirmation the acceptance of which binds him to the same restriction, and (c) that any offering materials and documents used in connection with offers and sales include statements about the restrictions on resale. Proposed Rule 903(c), Securities Act Release No. 6779, supra note 1.

tal markets by directed selling efforts is appropriate because (1) U.S. registration of foreign transactions should not be required, based on comity considerations, (2) non-registration in these situations would eliminate the problems raised under U.S. securities laws based on the difference between primary and secondary offerings, and (3) there is little potential for evasion.

The principle of international comity has been described by the Supreme Court as

neither a matter of absolute obligation, on the one hand, nor of mere courtesy and good will, upon the other. But it is the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.40

It seems appropriate to draw this line between U.S. law and foreign law, with respect to application of U.S. registration provisions, based on whether or not a foreign issuer has entered U.S. markets voluntarily.41

It was probably never intended that the registration provisions would apply to an offering by a foreign issuer in a foreign market, because it was thought that jurisdictional means would not be used in such an offering. With the increasing participation of U.S. underwriters in those offerings and the expansive definition of use of interstate commerce, however, foreign issuers often do not feel comfortable relying on the lack of jurisdiction and, accordingly, take precautions to assure securities will not be sold to U.S. persons. It is, of course, difficult for foreign issuers to understand why this step is required when they make an offering in a non-U.S. market.

As explained above, it is an interesting question why U.S. persons should be “protected” by Section 5 when they purchase securities from

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41 This basis was considered, in fact, in providing foreign private issuers with an exemption from registration under Section 12(g) of the Exchange Act pursuant to Rule 12(g)(3)-2(b). See Foreign Securities Act Release No. 6493, [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,435 (Oct. 6, 1983). The theory for granting an exemption for Section 12(g) to foreign private issuers who have not voluntarily accessed U.S. capital markets is valid. The rule seems to have been abused recently, however, by issuers who use the exemption to establish a market in the United States over-the-counter market. Issuers often conduct road shows to initiate this U.S. market. Under the Proposal, these road shows would be treated as special selling efforts and would not be permitted without registration. It is suggested that Rule 12(g)(3)-2(b) be limited as well.
a foreign issuer as part of a new distribution when they could purchase the same securities in foreign secondary markets at any other time. The Commission Proposal would eliminate this "protection," as well as the resulting confusion.

The evasion potential would also appear to be slight because no solicitation would be permitted in the United States. Without such efforts, it may be difficult for the foreign issuer to generate U.S. interest for its securities. In addition, a trading market on a U.S. securities exchange or NASDAQ\textsuperscript{42} could not be established without registration under the Exchange Act. The lack of a U.S. market may make it difficult to retain U.S. interest in the securities.

Of course, it is a strong possibility that, in light of telecommunications, U.S. persons will become aware of foreign offerings even though no direct solicitations are made in the United States. They could then purchase those securities in a foreign market without the protection of U.S. law. Nevertheless, if U.S. persons take the initiative and purchase securities in foreign offerings without having been solicited, they should do so at their peril. To ensure U.S. investors are not misled into believing U.S. securities laws protect them when they purchase in foreign markets through a U.S. broker-dealer, however, it may be wise to require the broker-dealer to disclose to purchasers that the securities have been purchased in the foreign market without the protection of U.S. securities laws. Such a warning may be particularly appropriate given the increasing participation of American investors in foreign markets, as they may not be aware that U.S. law does not protect them.

4.1.2 Non-reporting U.S. Issuers

Under the Commission Proposal, non-reporting U.S. issuers would not be entitled to the same treatment as foreign issuers because of the increased potential for evasion. This is a reasonable distinction. U.S. investors are more likely to purchase securities of U.S. issuers because of their greater familiarity with those companies. As a result, it may be easier for a U.S. issuer to sell to U.S. investors through the facilities of foreign markets without soliciting investors in the United States. In addition, it is more likely that the securities of a U.S. issuer initially sold abroad would be resold in the United States than would securities of a foreign issuer. Some may argue that this is unfair to U.S. issuers. One of the primary reasons for the inapplicability of Section 5 to non-reporting foreign issuers, comity, is nonexistent in the case of

\textsuperscript{42} NASDAQ is an automated inter-dealer quotations system operated by the National Association of Securities Dealers.
U.S. issuers. Moreover, the potential for evasion is greater. While it is important to maintain equal treatment of foreign and domestic issuers to the extent possible, in this case the cost of doing so is too great.

4.1.3 Reporting Issuers

The Commission's Proposal also makes it easier for reporting companies to place securities overseas by easing come-to-rest restrictions. This is a step toward reversing the illogical position that come-to-rest restrictions imposed on securities of reporting issuers must be more stringent than those placed on securities of non-reporting issuers because it is more likely securities of reporting companies will flow into the United States.

The Commission recognizes that the distinction between purchases of securities in the primary markets and purchases in the secondary markets by U.S. investors poses a problem and contends that the distinction would be lessened by the territorial approach. 43 This is true with respect to purchases by U.S. investors of securities of foreign issuers that are not traded in the United States, but the distinction remains intact with respect to the securities of reporting companies. U.S. persons cannot purchase the securities of reporting companies in a primary distribution unless the distribution is registered under the Securities Act. Yet, U.S. investors may purchase securities of the same issuer in the secondary markets during the foreign distribution at a price that presumably reflects the impact of the foreign distribution. 44 Does this make any sense?

If securities may be sold overseas with minimal come to rest restrictions and soon thereafter resold into the United States, while an offering on U.S. soil requires registration, it is likely that many offerings will be driven from U.S. markets. In that case, U.S. investors would be excluded from the initial offering and limited to whatever price resulted in the secondary markets. In addition, the issuer would be required to close its ADR facility while the overseas distribution took place, with an impact on the market price that is both unclear and artificial.

The Commission notes that a portion of most offerings by report-
ing companies is registered in the United States anyway. Perhaps so, but unless the issuer has been a reporting company for more than three years and meets the "float" tests of Form S-3, registration under the Securities Act can be costly. Perhaps as the markets continue to internationalize, more issuers that do not meet the S-3 criteria will consider making offerings abroad without registering in the United States. In addition, what assurance can be given that issuers will continue to follow the practice of registering in the United States when the advantages of making a foreign offering are increased? In particular, the ease with which securities purchased in a private placement may be resold onto a foreign exchange may curb the practice of registration in the United States.

If the securities are not registered in the United States, there is a gap in information provided to the marketplace as there is no mechanism, such as a filing requirement, for providing the information. And, if all offerings by reporting companies are registered in the United States, what is the point of the 90-day restrictions? Why not just require some form of registration?

The Commission states that its intent in requiring a 90-day period in which securities may not be sold to U.S. persons is to prevent sales while the market is "preconditioned." But, will not the price of the securities in the secondary markets be affected by the "selling efforts" anyway and would it not be better to assure there is some information in the U.S. markets about the distribution instead of excluding U.S. persons from participating?

In addition, in the case of continuous offerings, if the reason for restrictions on sale is to prevent sales while the market is preconditioned, the only logical conclusion is to restrict sale to U.S. persons until completion of the entire distribution. On the other hand, if information about the distribution were available in the U.S. secondary markets, this artificial barrier to shelf registrations would not exist.

\textsuperscript{46} Form S-3, 17 C.F.R. § 239.13 (1988), may be used for a primary offering (other than an offering of investment grade debt, or rights offerings, reinvestment plans or conversions or warrants) only if

the aggregate market value of the voting stock held by non-affiliates of the registrant is $150 million or more, or alternatively, the aggregate market value of the voting stock held by non-affiliates of the registrant is $100 million or more and the registrant has had an annual trading volume of such stock of 3 million shares or more.
4.1.4 Resales

In the case of resales, the most interesting provision of the proposal is the permission of immediate resales onto foreign exchanges of securities of reporting issuers and non-reporting foreign issuers with no U.S. market interest. This provision makes it advantageous for those issuers to make a private placement in the United States instead of a public offering. Presumably, a similar price could be obtained for the “restricted” securities (since they can be resold immediately) as for registered securities. Also, if the Proposal is adopted, why would anyone holding restricted securities wait for two years to sell them onto a U.S. market if a foreign market exists? Thus, the provision may provide an incentive for issuers to establish markets abroad, and place their securities privately in the United States.

5. MOVING BEYOND THE PROPOSAL

These problems continue in spite of the Commission’s excellent Proposal because Section 5 remains in the way. Because of Section 5, it is advantageous to make sales in foreign markets and enjoy the beneficial non-registration treatment. It seems that the Commission would like to make a greater regulatory distinction between reporting and non-reporting issuers, but does not feel justified in doing so because of Section 5. The Commission in fact states in the proposing release that “[i]n the event flowback of securities in this category [reporting issuers] does occur after the restricted period, the information relating to such securities publicly available under the Exchange Act should be sufficient to ensure investor protection.” Instead, the primary/secondary distinction remains, artificial come-to-rest restrictions, though lessened, continue, and U.S. investors are actually provided less information because 90 days after a distribution by a reporting company the securities may trade here without any regulatory filing.

In my view, the key to implementing a modified territorial approach is to eliminate Section 5 registration requirements for all reporting companies, both domestic and foreign, that have filed one of Forms 10, 10-K or 20-F and to impose instead a notification of offering re-
requirement on Form 8-K. Of course, it is important to retain Section 5 protection (including Section 11 liability) for initial public offerings in the United States by either domestic or foreign issuers to assure that investors are provided with information not previously available in the market.

It is likely that the principal objection to this approach will be the elimination of Section 11 liability for offerings by reporting companies. An answer to this objection is to achieve the protection in another manner—increase the liability of issuers for Exchange Act reports, particularly for the report suggested below to be used to notify all investors of offerings. Maintaining the present, outdated system is too high a price to pay solely to retain Section 11 protection.

When a company that has securities traded in established secondary markets (and thus is required to file reports under the Exchange Act) makes a new offering, it is questionable whether purchasers in that offering need any more information than purchasers in the secondary market. All purchasers, including those purchasing in the secondary market, need to know of the existence of the offering. Requiring registration of the new offering is an inefficient method of providing this information. A better approach would be to require prior notification by a filing on Form 8-K that would then be available to both those with voting stock of an aggregate value worldwide held by nonaffiliates of the equivalent of $300 million or more and for investment grade debt securities. Form F-2 requires that a copy of the registrant's Form 20-F be delivered with the prospectus, however. An alternative approach would be to eliminate the Section 5 requirement for issuers who have been reporting for one year. This should address any concern that information is not adequately disseminated until an issuer has been reporting for a period of time. There should be no need for such concern following complete implementation of the Commission's electronic data gathering and retrieval system, however. See infra text accompanying note 76.


It also seems anomalous that persons who purchase securities as part of a new distribution are provided the full protections of liability under Section 11 of the Securities Act, while purchasers in the secondary market are left with only the protections of anti-fraud provisions. Of course, this distinction is also present in domestic markets. See supra text accompanying note 25.

Form 8-K is an Exchange Act filing used to report material events. The Form should be on file for a specified time period prior to any offers or sales. It could contain as much information about the offering as the Commission believes is appropriate. Prior to implementation of Edgar (See infra note 76), rules requiring adequate dissemination of this notice filing to the investing public may be appropriate. See, e.g., 17 C.F.R. § 230.461 (1988) (establishing availability of adequate information to the public as a criterion for accelerating the effective date of a registration statement). Foreign issuers are not currently required to file Form 8-K. The proposal would require all reporting issuers, foreign or domestic, to file Form 8-K for this purpose.
groups of purchasers. The requirement of registration and delivery of a prospectus and Section 11 liability are more appropriate for initial public offerings because those offerings are more likely to be accompanied by special selling efforts and possible pressure to purchase. Although it may be argued that such pressure exists in distributions by reporting issuers, there is certainly less pressure and in any event the price of the securities in the secondary markets will also be impacted by the distribution. Thus, all purchasers during the time of the new distribution need similar protection. Any concern with pressure in offerings by reporting issuers can be best addressed by imposing an adequate waiting period prior to sales, and requiring dissemination of the Form 8-K to underwriters and dealers who will participate in the distribution.

5.1 Development Of The Theme

This is not a new concept. In fact, many of the suggestions in this article simply develop themes that have been evolving in domestic securities regulation and use those themes to solve problems in international securities regulation. The proposed reliance on the Exchange Act for dissemination of information further extends the principles of the integrated disclosure system. It also follows the lead of the ALI Code and, as discussed above, the Proposal recognizes developments in the Exchange Act in suggesting shorter come-to-rest provisions for reporting companies.

With the adoption in 1964 of Section 12(g) of the Exchange Act, which imposes a disclosure obligation on issuers with securities traded in over-the-counter markets, increased integration of the reporting

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52 Companies that sell securities abroad often register those securities in the United States in a "flowback" registration. In such a registration, securities are registered for resale in the United States so that the securities may be freely resold here and come-to-rest restrictions need not be imposed on the securities. To accomplish this, companies that have not been reporting under the Exchange Act for 36 months must file a full registration statement, as opposed to a "short form" registration statement, on Form S-2 or 3 or F-2 or 3. Under the proposed system, only a Form 8-K would be required to notify purchasers of the offering, and the need for a flowback registration would be eliminated. See Adee, Flow-back Registration Statements, Insights, April 1988, at 10.

53 See supra note 17.

54 See, e.g., 17 C.F.R. § 230.460(b) (1988) (requiring distribution of information to underwriters and dealers a reasonable time in advance of the anticipated effective date of the registration statement).


56 See supra text accompanying note 43.

provisions of the Exchange Act and the Securities Act became possible. Prior to adoption of Section 12(g), only those corporations which had registered securities under the Securities Act or which had securities listed on exchanges were covered by the reporting provisions of the Exchange Act. Emphasis could not readily be placed on improved reporting under the Exchange Act and incorporation by reference into Securities Act documents because corporations could delist and trade over the counter. Following adoption of Section 12(g), “commentators suggested that the large reservoir of continuously updated information accumulated under the Exchange Act might be utilized in partial or total substitution for the sporadic, and often duplicative, disclosure provided in registration statements under the [Securities] Act.”

In 1969, an internal study group was formed by the Commission to determine what steps it might take to integrate the Acts. A report was issued (the “Wheat Report”) and forms were adopted as an initial step in the process. In 1977, an advisory committee (the “Advisory Committee”) on corporate disclosure recommended further integration of the Acts to, as the Advisory Committee put it, “curtail registration costs and administrative obstacles incurred by industrial issuers in raising capital, facilitate timely access to the capital markets, and simplify the exchange offer and business combination processes.”

Reliance on Exchange Act reports for information about companies was then suggested by the ALI Code. The ALI Code would have established a system of company registration with continuous disclosure as a substitute for registration of each transaction in which securities are issued. Under the Code, a corporation would file a registration statement when it had at least $1 million of total assets and 500 holders of its securities. Once a corporation became a registrant, it would have been subject to continuous reporting provisions. The ALI Code would have required filing of an offering statement and delivery of a prospectus in connection with “distributions.” The task of specifying how much of the contents of offering statements and prior filings should be included in a prospectus, however, was left to the Commis-
sion. In making that determination, the Committee was directed to consider whether the issuer was a one-year registrant. 63

The Commission acted to adopt the integrated disclosure system in 1982, implementing many of the concepts proposed by the various groups. 64 Currently, under the integrated disclosure system, issuers that have been reporting under the Exchange Act for at least 36 months may file a short-form registration statement that incorporates by reference reports filed under the Exchange Act into the Securities Act registration statement. Although purchasers of securities sold as part of the distribution receive a prospectus, that prospectus contains only information about the transaction, usually including a description of the securities to be sold. For information about the issuer, prospective purchasers must obtain documents already on file at the Commission pursuant to the Exchange Act.

Most recently the Commission took a further step in connection with sales of securities to employees of non-reporting issuers that are exempt from registration pursuant to Rule 701. 65 Although securities purchased pursuant to that rule are "restricted securities" and cannot be freely resold while the issuer is a non-reporting issuer, the securities may be sold in brokerage transactions without further restriction 90 days after the issuer becomes a reporting issuer. In permitting this type of resale, the Commission has recognized the importance of available information under the Exchange Act and the lack of a need for registration of these resales.

5.2 Continuing Issues

The same concerns that have been raised each time a new step is taken to further integrate the Acts continue to arise. The principal issues are (1) whether information is adequately disseminated so that the law may dispense with a prospectus delivery requirement in the circumstances, and (2) whether further reliance on Exchange Act reports would erode investor protection afforded by the liability provisions of Section 11.

With respect to the first issue, it is recognized that the prospectus delivery requirement serves a useful purpose. As stated by Milton H. Cohen in "Truth in Securities Revisited," the requirement compels "written communications of specified information to purchasers and

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63 See ALI Code, supra note 12, at § 505(a).
64 See supra note 11.
66 Affiliates are subject to the restrictions of Rule 144 other than the holding period.
prohibit[s] other written communications (except specifically defined and limited ones) until the required prospectus has been delivered." 67

Both the Advisory Committee and the study group that drafted the Wheat Report recognized that one purpose of the prospectus was to deter fraudulent sales pitches and overzealous sales efforts, a problem that is especially acute in initial public offerings. 68 As recognized by the Advisory Committee, however, although the prospectus was expected to "secure for potential buyers the means of understanding the intricacies of the transaction ... [t]he impact may have been diminished by the fact that oral offers could be made, and sales consummated, without delivering the required prospectus until the security was delivered." 69

The question of liability is, of course, closely related to the prospectus delivery issue. That is, for reporting companies, should a distinction be made between protection afforded to investors in secondary trading markets from that provided investors in the primary distribution? Is additional protection required because of special selling efforts that may accompany a new issuance?

The Advisory Committee recognized the idiosyncrasy of the distinction between the protection in prospectus delivery provided to purchasers in primary distributions and in secondary markets and the liability that results in each market, stating that "[a]side from the legal distinctions imposed under securities laws, there is very little difference from an investor's point of view between a security purchased directly from an issuer and the same security acquired from another investor, except possibly the liquidity of the investment ... ." 70

The "fraud-on-the-market theory" further supports this view. As described by the Supreme Court in Basic Inc. v. Levinson, "the fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company." 71

The Court there notes that empirical studies have tended to confirm Congress's premise that the market price of shares traded on well-de-
veloped markets reflects all publicly available information. That theory recognizes that an investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price and that reliance on public misrepresentations may be presumed. Likewise, the trading price in the secondary markets presumably reflects the impact of a distribution. Under this theory, the utility of keeping securities in new distributions out of U.S. markets during the first 90 days of a distribution should be questioned. In its release adopting the integrated disclosure system in 1982, the Commission also recognized that, if information is material information (other than a description of the transaction itself), then it will be material both in the distribution of securities and to the trading markets.

Mr. Cohen was not troubled by these two often-cited criticisms of such a system when he suggested a system similar to that proposed in this article: a filing in a registrant’s continuous disclosure file when there is a new distribution of securities by a registrant. He stated: “In strict logic I find it much easier to defend the proposition that there should be no prospectus requirement than that the present requirement should prevail, when securities of a continuous registrant are being offered.” The reason for this position was similar to that suggested in this article—that persons purchasing in the secondary trading markets require similar protection to those purchasing in a primary distribution.

5.3 Further Adoption Of These Principles

When the Commission adopted the integrated disclosure system, condensing prospectuses was a bold, experimental step. The Commission therefore limited the full impact of the integrated disclosure system to certain companies whose reports are widely followed. In view of the problems caused by internationalization and the trend toward increased reliance on Exchange Act reporting, it is time to rely even more heavily on Exchange Act reporting by eliminating Section 5 requirements in appropriate circumstances. While market changes are a sufficient reason for making this change, technological advances that facilitate access to Exchange Act reports will ease this transition. In 1966, Milton H. Cohen looked to the future and predicted that “advances in the technology of electronic data processing will rapidly open up revolutionary new possibilities for dissemination of filed information, a potential de-

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72 Cohen, supra note 49, at 1384.
velopment whose importance and promise must surely receive considerable attention in devising a coordinated disclosure law." He went on to state his belief that "the real hope and challenge lies in advanced applications of electronic data processing and photocopying techniques that, imaginatively used, may affect—indeed, transform—the entire disclosure system in coming years."

Participants in the markets already can rapidly transmit documents pulled from Commission files. The process of obtaining documents filed with the Commission will be even easier once the Commission's electronic data gathering and retrieval system ("Edgar") is operational. Financial advisors will be able to purchase a database to access the documents quickly, and, eventually, potential investors should have access to reports on file with the Commission through their home computers.

Elimination of registration requirements for reporting issuers would remove the distinction between primary and secondary offerings that causes problems in international markets. Reporting issuers, both domestic and foreign, could make an offering abroad without imposing come-to-rest restrictions under Release 4708 and could allow American investors to participate in the offerings without registration. Those securities could be freely resold in the United States, provided the issuer had filed a Form 8-K in connection with its foreign offer, because information about the issuer and the transaction would be available to investors. With the elimination of Section 5 requirements for reporting issuers and the increased reliance on Exchange Act reports, there would no longer be cause for concern that an issuer was evading Section 5 by selling securities abroad without registration and shortly thereafter registering its securities under the Exchange Act. Reporting issuers would not have a Section 5 obligation to avoid, and, in addition, information would be available to purchasers in the secondary markets.

Although the need for this is prompted by the internationalization process, registration requirements should be eliminated for all reporting issuers, domestic or foreign. The same argument for elimination of Sec-

74 Id. at 1361.
75 Id. at 1376.
77 Adoption of the proposed system may require legislative action to eliminate registration requirements for reporting issuers. In the absence of such legislation, similar goals could be achieved through amendments to the integrated disclosure system. Specifically, the 36-month period required before reports may be incorporated by reference could be replaced with a requirement that an issuer first file a Form 10, 10-K or 20-F before short-form prospectuses would be permitted.

https://scholarship.law.upenn.edu/jil/vol10/iss2/3
tion 5 applies in the domestic context: purchasers in secondary markets and purchasers in a primary offering require similar information about the distribution.

6. Conclusion

The Securities Act was created more than 50 years ago when securities markets were less complex and securities were traded primarily in domestic markets. Changes in technology have been responsible for changes in securities markets, and they make it easier to provide pertinent information to investors. These advancements in technology provide the key to regulatory change. As investors have ready access to Commission reports—and will have even greater access with the implementation of Edgar—the complex registration and prospectus delivery system required by the Securities Act has become less important. Thus, the technology that has made it possible for the securities markets to become international should now make it possible to provide more efficient regulation.