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Regulation S Selling and Transfer Restrictions: A Basic User's Guide[1]

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Selling and transfer restrictions are part and parcel of the international securities lawyer's daily bread. Because of their very ubiquity, they can fail to receive due consideration, with junior lawyers being left to struggle through what they take to be relatively insignificant boilerplate. Of course, the restrictions are neither boilerplate nor insignificant, with mistakes in them potentially resulting in violations of Section 5 of the Securities Act of 1933, as amended, and comparable provisions in other jurisdictions, thereby possibly giving rise to rescission and damages claims. In this article, we revisit the fundamental principles underlying selling and transfer restrictions in the context of Regulation S offerings and discuss certain associated market developments. We also address the closely related area of tax selling and transfer restrictions under the anti-bearer bond rules of the U.S. Tax Equity and Fiscal Responsibility Act (TEFRA). Compliance with these rules is critical when offering debt securities in bearer form, particularly because TEFRA restrictions are similar to, but more prohibitive than, corresponding restrictions under Regulation S.

Brief History of Regulation S

The Securities Act does not provide a specific exemption for offers and sales of securities outside the United States. Section 5, the provision setting out the registration requirement, contains a jurisdiction-limiting reference to "interstate commerce." However, this concept, as elsewhere in the law, has been very broadly construed in practice. The chief statutory exemptions from registration also contain similarly ambiguous terms. The

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[1] This article draws principally from *U.S. Regulation of the International Securities and Derivatives Markets,* 10th ed., by Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A Braverman, Sebastian R. Sperber and Nicolas Grabar (Wolters Kluwer Law & Business 2012) (hereinafter, the "ISDM"), particularly Chapter 6 thereof. The authors wish to express their gratitude, in particular, to Messrs. Leslie N. Silverman and Sebastian R. Sperber of Cleary Gottlieb Steen & Hamilton LLP for their general comments and suggestions.

definition of "underwriter" for purposes of Section 4(a)(1),[2] which exempts offers and sales by anyone other than an issuer, underwriter or a dealer, refers to anyone who purchases from an issuer with a view to the "distribution" of the securities. "Distribution" is not defined and, given historical concerns about flowback of securities into the United States, it was not clear that it excluded offshore offerings. Section 4(a)(3) exempts offers and sales by dealers that are not "underwriters," provided that the offers and sales do not take place within the 40 days after the securities are first "offered to the public" and are not part of an "unsold allotment."[3] Again, the concept of "offered to the public" is not obviously limited just to U.S. public offerings.

Acknowledging the uncertainty resulting from the absence of express relief in the Securities Act for offshore offerings, the SEC published Release No. 33-4708 in 1964. In this predecessor to Regulation S, the SEC recognized that the securities laws were "primarily intended to protect" U.S. investors and indicated that registration could be avoided in certain circumstances, including where steps were taken to "preclude distribution or redistribution" of the securities to U.S. persons or where the securities would "come to rest" abroad. To implement these ideas, the bar developed a number of practices, such as limiting the availability of securities in definitive form until 90 days after completion of the distribution and having the underwriters agree that they would not sell unsold allotments to U.S. persons during this period and that they would deliver confirmations to other dealers imposing the same restrictions on them.[4]

Despite the advances made by Release No. 33-4708, significant uncertainties remained. In particular, full application of the procedures to offerings of equity securities proved impracticable and interpretive questions remained with respect to matters such as how to analyze resales of securities sold outside the United States. In addition, the growth of global markets and the desire of institutional investors to purchase the securities of foreign issuers offshore suggested that a more territorially circumscribed regulatory approach would be appropriate.

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2 The Jumpstart Our Business Startups Act (the "JOBS Act"), enacted in April 2012, renumbered Section 4 by inserting subsections (a) and (b). Sections 4(1), 4(2), 4(3) and (4) are accordingly now referred to as Sections 4(a)(1), 4(a)(2), 4(a)(3) and 4(a)(4), respectively.

3 A full discussion of Section 4(a)(3) and its implications is beyond the scope of this article.

4 *See* Alan L. Beller and Gail S. Berney, *Eurobonds*, 19 Rev. Sec. Comm. Reg., No. 4 (1986), cited in the ISDM, Chapter 6.01[1].

Regulation S Overview

To respond to these issues, the SEC adopted Regulation S in 1990.[5] The regulation consists of a general statement and two safe harbors. The general statement indicates that the registration requirements of the Securities Act apply only to offers and sales of securities made in the United States. Of course, the general statement alone generally is insufficient for purposes of structuring an offering;[6] however, it is worth noting as an indication of the SEC's response to the problems leading up to the regulation, as well as the regulation's generally territorial approach.[7] The first safe harbor covers offers and sales by issuers and other distribution participants, as well as their affiliates. The second covers resales by others, such as investors acquiring the securities in a U.S. private placement (*e.g.*, pursuant to Rule 144A).[8]

Key Terms

To facilitate discussion of the safe harbors, a brief overview of key concepts used in Regulation S is helpful:

Term	Concept
Directed Selling Efforts.......	Any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on Regulation S. Examples include the following:

5 *See* SEC Release No. 33-6863 (Apr. 24, 1990). In 1998, the SEC further amended Regulation S to address its abuse by certain U.S. issuers seeking to avoid registration under the Securities Act. *See* SEC Release No. 33-7505 (Feb. 17, 1998). This article discusses Regulation S, as amended, except where otherwise indicated.

6 Issuers and underwriters may request a legal opinion from U.S. counsel that no registration under the Securities Act is required. U.S. counsel generally will not provide such an opinion without the conditions of the relevant safe harbor being met.

7 Although the general statement generally should not be relied upon when structuring an offering, it is more than a mere statement of principle. For example, it may provide a safety net in the context of inadvertent violations of the terms of the safe harbors in Regulation S—*e.g.,* where a press release accidentally is published without an appropriate legend or a press release intended for distribution only offshore mistakenly is sent into the United States. Depending on the facts and circumstances of the situation, offering participants may be able to conclude that Section 5 of the Securities Act has not been violated on the basis of the general statement.

8 The first safe harbor is in Rule 903 and the second in Rule 904. All references to "Rules" in this article are to rules under the Securities Act, unless otherwise indicated.

- sending promotional materials (including research reports not satisfying the requirements of Rules 138 or 139)[9] to U.S. investors;
- holding promotional seminars for U.S. investors; and
- placing advertisements in publications with a general circulation in the United States.

However, activities that are countenanced by the securities laws or are otherwise routine and unconnected with the offering should not constitute directed selling efforts. Examples include the following:

- meeting with qualified institutional buyers (often referred to as "QIBs") in roadshows in a simultaneous U.S. private placement;[10]
- issuing press releases under Rule 135, Rule 135c or Rule 135e;[11]
- press conferences outside the United States open to U.S. and non-U.S. journalists, as permitted by Rule 135e;
- customary marketing activities conducted offshore and permitted by local law;[12] and
- routine press releases, even including results announcements.

Offshore Transaction........... In general, an offer or sale of securities is made in an "offshore transaction" if the offer is not made to a person in the United States, and either:

- at the time the buy order is originated, the buyer is outside the United States, or the seller and any person acting on its behalf reasonably believe that the buyer is outside the United

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[9] Rules 138 and 139 provide that certain research reports are not "offers" for purposes of the registration requirements of the Securities Act.

[10] Even in the absence of a simultaneous U.S. private placement, roadshows presented in the United States to persons not falling within the definition of "U.S. person" (*e.g.*, discretionary onshore managers of offshore funds, as discussed further below) may be permissible, though particular care should be taken to ensure that they do not amount to directed selling efforts and thereby undermine the availability of Regulation S.

[11] Rules 135, Rule 135c and Rule 135e provide that certain publicity activities are not "offers" for purposes of the registration requirements of the Securities Act.

[12] *See* Coral Gold Corporation (avail. Feb. 19, 1991).

States;[13] or

- for purposes of an offering by an issuer, an underwriter or other distribution participants, the transaction is executed on or through a physical trading floor of an established foreign securities exchange located outside the United States;[14] or
- for purposes of resales, the transaction is executed in, on or through the facilities of a designated offshore securities market, and neither the seller nor any person acting on its behalf knows that the transaction has been pre-arranged with a buyer in the United States.

In addition, offers and sales to any discretionary or similar account (other than an estate or trust) held for the benefit or account of a non-U.S. person by a dealer or other professional fiduciary organized, incorporated or resident in the United States are deemed to be "offshore transactions."[15]

Substantial U.S. Market Interest (SUSMI) .... A determination of whether there is SUSMI is based on the issuer's reasonable belief at the commencement of an offering.

For a class of equity securities, there is SUSMI if, in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation:

- U.S. securities exchanges and inter-dealer quotation systems (including the "pink sheets" over-the-counter market) constituted the single largest market for that class; or

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13 For a corporation, partnership or investment company, an authorized employee or (in the case of an investment company) authorized adviser outside the United States satisfies this condition. It is not necessary to consider where the investment decision leading to the purchase is made. *See* SEC Release No. 33-6863 (Apr. 24, 1990), note 39 and accompanying text.

14 In a number of cases, electronic trading systems have replaced physical trading floors. Electronic dealer-to-dealer systems involve transactions with known counterparties and therefore cannot readily be analogized to physical trading floors. However, where electronic trading systems anonymously match trades and maintain the anonymity of purchasers, they function in a manner similar to the auction model of a physical trading floor. Accordingly, the seller should be able to rely on Rule 903 by analogy (assuming the rule's other requirements are satisfied). In cases where this is not possible, the seller nonetheless may be able to sell its securities by relying on another exemption from registration, such as Rule 144 (discussed further below).

15 In connection with establishing their customer contacts and maintaining their customer lists, underwriter sales forces often will have confirmed with potential customers their QIB or other relevant status (*e.g.*, discretionary onshore manager of offshore funds) in order to ensure that offers extended to them comply with Rule 144A or Regulation S.

- 20% or more of all trading in such class took place in, on or through the facilities of U.S. exchanges or inter-dealer quotations systems and less than 55% of such trading took place in, on or through securities markets of a single foreign country.

For debt securities, there is SUSMI if:

- the issuer's debt securities, in the aggregate, are held of record by 300 or more U.S. persons;
- $1 billion or more of the principal amount outstanding of its debt securities is held of record by U.S. persons; ***and***
- 20% or more of the principal amount outstanding of its debt securities is held of record by U.S. persons.[16]

For guaranteed debt securities, SUSMI is determined on the basis of the outstanding debt of the parent where the guarantor is the parent of the issuer. For all other guarantees, the debt of both the guarantor and the issuer must be considered; if SUSMI exists in either case, then Category 1 is not available.[17] SUSMI should be determined on the basis of all debt securities issued or guaranteed by the relevant entity.[18]

U.S. Person

"U.S. person" includes, among others:

- Any natural person resident in the United States.
- Any partnership or corporation organized or incorporated under the laws of the United States.

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16 Outside the United States, issuers sometimes issue debt in bearer form. For purposes of Regulation S, record holding includes securities in bearer form. However, it is unclear how to form a "reasonable belief" about SUSMI in instruments in bearer form (unless the issuer has less than $1 billion of debt securities outstanding, in which case there can be no SUSMI in its debt securities by definition). Where the issuer has more than $1 billion of debt securities outstanding worldwide, practitioners nonetheless may countenance a finding that there is no SUSMI where the issuer (i) has not offered any of the securities in the United States, (ii) has no securities (including equity) listed in the United States and no SEC-registered over-the-counter ADR program and (iii) is not otherwise aware of significant holdings of its debt securities by U.S. investors.

17 We understand that in the case of debt securities guaranteed by subsidiaries of the issuer, the SEC staff informally has indicated that a subsidiary guarantor can rely on the status of its parent, so long as the requirements of Rule 3-10 of Regulation S-X are met. Rule 3-10 requires that the subsidiary guarantor be wholly owned by the issuer and that it fully and unconditionally guarantee the parent's securities.

18 A letter of credit should be treated as a guarantee for purposes of making a SUSMI determination.

- Any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person.
- Any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated or resident in the United States, unless such account is held for the benefit or account of a non-U.S. person.

"U.S. person" excludes, among other persons, U.S. citizens resident in other countries[19] and an employee benefit plan established and administered in accordance with the law of a country other than the United States and the customary practices and documentation of such country.[20]

The First Safe Harbor: Offers and Sales by Issuers and Distribution Participants under Rule 903

The first safe harbor applies to issuers, underwriters, selling group members and others that participate in the distribution of the securities pursuant to a contractual arrangement. Two conditions must be satisfied for an offer or sale to qualify: (i) the offer and sale must be an "offshore transaction," and (ii) there may be no "direct selling efforts."

Further Requirements: Categories 1, 2 and 3[21]

In addition to the offshore transaction requirement and prohibition on directed selling efforts, further requirements might have to be met to qualify for the first safe harbor. The applicable requirements depend on the extent to which there is a nexus

19 Notwithstanding the exclusion of U.S. citizens resident abroad, offers and sales specifically targeting identifiable groups of U.S. citizens abroad, such as members of the military serving overseas, will not be deemed "offshore transactions." *See* Rule 902(h)(2).

20 Regulation S does not deal expressly with offshore transactions involving U.S. pension funds, and an offer or sale to a fiduciary outside the United States acting with discretion for the fund should qualify as an offshore transaction. However, there is some uncertainty as to the appropriate treatment of certain offshore accounts of U.S. pension funds under the "U.S. person" definition. U.S. pension funds generally are organized as trusts and Regulation S treats a trust having a U.S. trustee as a U.S. person unless "a trustee who is not a U.S. person has sole or shared investment discretion with respect to the trust assets, and no beneficiary of the trust . . . is a U.S. person." *See* Rule 902(k)(2)(iii). Accordingly, a discretionary account of a U.S. pension fund held by a foreign fiduciary may be a U.S. person because the trustee commonly is a U.S. person and the beneficiaries (*i.e.*, the employees) typically include U.S. persons.

21 *See* Appendix A for a summary overview table of Categories 1, 2 and 3, as well as the key restrictions each category imposes.

with the United States, with more stringent requirements applying the greater the need is for protection of U.S. investors. The spectrum ranges from Category 1, where the likelihood of the securities flowing back into the United States is most minimal, to Category 3, where that likelihood is greatest.

Category 1. Category 1 applies to offerings of securities of foreign private issuers[22] that do not have SUSMI.[23]

If an offering falls within Category 1, Regulation S does not impose any requirements beyond the offshore transaction requirement and the prohibition on directed selling efforts.[24]

Category 2. Category 2 offerings comprise:

- debt offerings of foreign private issuers that are not eligible for Category 1;
- equity offerings of foreign private issuers that are not eligible for Category 1, provided the issuers are subject to the reporting requirements of the Securities Exchange Act of 1934, as amended; and
- debt offerings of U.S. issuers, provided the issuers are subject to the reporting requirements of the Securities Exchange Act.

If an offering falls within Category 2, Regulation S imposes certain additional requirements beyond the offshore transaction requirement and the prohibition on directed selling efforts. The principal difference from Category 1 is that the securities may not be offered or sold to U.S. persons, even if outside the United States. Under Category 1, the securities may be offered and sold to U.S. persons outside the United States.

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22 Category 1 also applies to offerings by foreign governments and certain offerings by foreign quasi-governmental bodies. *See* Rule 903(b)(1)(iii). The focus of this article is on private issuers.

23 "Overseas directed offerings" also fall within Category 1. In these offerings, the securities of a foreign issuer are offered and sold to residents of a single foreign country in accordance with local law and practice. The securities of a U.S. issuer also are eligible for an overseas directed offering, provided they are non-convertible debt securities that are not U.S. dollar-denominated. Notwithstanding the one-foreign country limitation, just as with other offerings under Regulation S, a simultaneous U.S. offering will not be integrated with an overseas directed offering, meaning that the two offerings may be made concurrently.

24 Offerings of equity securities of non-reporting foreign private issuers where there is no SUSMI are sometimes colloquially referred to as "Category 0" offerings because they present a very low risk of flowback into the United States.

Under Category 2, the offering is subject to a "distribution compliance period" during which distributors may not offer or sell the securities to, or for the account or benefit of, a U.S. person (other than a distributor). The distribution compliance period applies to unsold allotments (*i.e.*, securities acquired from the issuer or any selling security holder, in an uninterrupted chain of transactions between dealers or in stabilization activities) at any time and, for other securities sold in the offering and acquired in the market, the period runs for 40 days from the later of the date the securities are first offered to the public and the closing date of the offering.[25] During this time, only offshore transactions to, or for the account or benefit of, non-U.S. persons are permitted pursuant to Regulation S. (Of course, as discussed below, concurrent sales to U.S. persons under Rule 144A are permissible.)

Category 2 also requires that "offering restrictions" be implemented. Offering restrictions require that:

- each distributor agree in writing (something that typically is done in the purchase agreement for the securities) that all offers and sales of the securities before the end of the distribution compliance period be made only in accordance with Regulation S, pursuant to registration of the securities under the Securities Act or pursuant to an exemption therefrom; and

- all offering materials other than press releases (*e.g.*, the offering memorandum) used in connection with the offering before the end of the distribution compliance period include statements to the effect that the securities have not been registered under the Securities Act and may not be offered or sold in the United States or to U.S. persons (other than distributors) unless the securities are registered under the Securities Act or an exemption therefrom is available; these statements should appear on the cover or inside cover page and in the offering restrictions section of the offering memorandum and in at least summary form in any advertisement in connection with the offering.

25 In other words, allotment securities, which includes securities acquired in an unbroken chain among dealers, are subject to permanent restrictions. Accordingly, allotment securities must be distinguished from securities purchased in secondary market transactions. However, a distributor with an unsold allotment of securities in a segregated identifiable account may sell other securities of the same class as if it were not a distributor, provided the other securities are not borrowed from and will not be replaced by securities from the unsold allotment. *See* SEC Release No. 33-6863 (Apr. 24, 1990).

In addition, Category 2 imposes a notice requirement under which each distributor selling the securities prior to the end of the 40-day distribution compliance period to a distributor, dealer or person receiving a selling concession, fee or other remuneration in respect of the securities sends a confirmation or other notice to the purchaser informing it that it is subject to the same restrictions on offers and sales that apply to the distributor.

Category 3. Category 3 offerings comprise:

- equity offerings of foreign private issuers not subject to the reporting requirements of the Securities Exchange Act but where there is SUSMI in the class of securities being offered;[26]

- all equity offerings of U.S. issuers; and

- debt offerings of U.S. issuers not subject to the reporting requirements of the Securities Exchange Act.

If an offering falls within Category 3, Regulation S imposes all the requirements of Category 2, as well as certain additional requirements (including, in particular, the purchaser certification requirements for equity securities described below). First, under the offering restrictions requirement, for offers and sales of equity securities of U.S. issuers, distributors must agree in writing not to engage in hedging transactions with regard to the securities before the end of the distribution compliance period unless in compliance with the Securities Act. Similarly, the legends required in offering materials and advertisements must include a statement that hedging transactions involving the securities may not be conducted unless in compliance with the Securities Act. This reflects the SEC's concern that hedging effectively could shift the economic benefits and burdens of the securities to the United States or to U.S. persons, thereby subverting the distribution compliance period.[27]

[26] Emerging market, non-reporting foreign private issuers sometimes are caught by Category 3 because there is SUSMI in their equity securities as a result of trading in their over-the-counter unrestricted ADR programs.

[27] In 1995, the SEC issued an interpretive release highlighting certain "problematic practices" relating to purported offerings of equity securities of U.S. issuers under Regulation S. Among these were "short selling and other hedging transactions such as option writing, equity swaps or other types of derivative transactions, where purchasers transfer the benefits and burdens of ownership back to the United States market during the restricted period." SEC Release No. 33-7190 (June 27, 1995) (footnotes omitted). As indicated in footnote 5, these and similar concerns resulted in the 1998 amendments to Regulation S.

When adopting the hedging-related requirements as part of the 1998 amendments to Regulation S, the SEC emphasized that they were not intended to impose any new restrictions on purchasers, but rather to put purchasers on notice of the potential Securities Act implications of hedging activity. *See* SEC Release No. 33-7505 (Feb. 17, 1998), note 29 and accompanying text.

Second, and more significantly, in the case of a debt offering, the securities must be represented by a temporary global note that is not exchangeable for definitive securities until the expiration of the 40-day distribution compliance period and, for persons other than distributors, until certification of beneficial ownership of the securities by a non-U.S. person or a U.S. person that acquired the securities in a transaction not requiring registration under the Securities Act.

Third, in the case of an equity offering, the distribution compliance period is lengthened to one year (or six months if the issuer is a current Securities Exchange Act-reporting issuer),[28] and any offers or sales made prior to the end of this period must satisfy the following conditions:

- the purchaser (other than a distributor) certifies that it is (i) not a U.S. person and is not acquiring the securities for the account or benefit of any U.S. person or (ii) a U.S. person that acquired the securities in a transaction not requiring registration under the Securities Act;

- the purchaser agrees to resell the securities only in accordance with the provisions of Regulation S or pursuant to registration under the Securities Act or an available exemption therefrom, and agrees not to engage in hedging activities with regard to the securities, unless in compliance with the Securities Act;

- the securities of a domestic issuer contain a legend indicating that transfer is prohibited except in accordance with the provisions of Regulation S or pursuant to registration under the Securities Act or an available exemption therefrom, and that hedging transactions involving the securities may not be conducted, unless in compliance with the Securities Act; and

- the issuer, either by contract or a provision in its organizational documents, refuses to register any transfer of the securities not made in accordance with Regulation S or pursuant to registration under the Securities Act or an available exemption therefrom; provided that if the securities are in bearer form or foreign law prevents the issuer from

[28] In December 2007, the SEC adopted amendments to Rule 144 that substantially reduced the holding periods applicable to the sale of restricted securities, among other things. In particular, the revised rule allows non-affiliates to resell freely the securities of a Securities Exchange Act-reporting company six months after issuance, so long as the issuer continues to report. At the same time, the SEC made conforming amendments to Category 3. *See* SEC Release No. 33-8869 (Dec. 6, 2007).

refusing to register such transfers, other reasonable procedures are implemented to prevent impermissible transfers.

Application to Convertible Bonds. In a convertible bond offering, the applicable category generally is the more restrictive of the categories applicable to the issuer's debt securities and the securities underlying the convertible bond.[29] Where the underlying securities are issued by the issuer's parent and the parent also guarantees the bonds, the relevant category is the more restrictive of the categories applicable to the parent's debt securities and to the parent's underlying securities. Where the guarantor of the bonds is not the parent, the relevant category is the most restrictive of the categories applicable to (i) the guarantor's debt securities, (ii) the issuer's debt securities and (iii) the underlying securities.

The application of Category 3 to convertible bonds issued by U.S. companies presented serious challenges to this large component of the international capital markets. Because convertible bonds typically are held in global form and traded through book-entry clearing facilities (*e.g.*, Euroclear, Clearstream and DTC), compliance with most of the requirements of Category 3 was not practical—in particular, the certification, purchaser resale agreement and stop transfer provisions. To address the problem by issuing definitive, registered certificates was not a realistic solution given the cost and long settlement periods that would be required. However, the potentially adverse consequences of a straightforward application of Category 3 in this context were avoided when the SEC staff elaborated a set of acceptable procedures in response to a no-action request.[30] Under the *Cravath* letter,[31] as it is commonly known, U.S. reporting issuers offering convertible or exchangeable securities eligible for Rule 144A resale and being held in global form for book-entry clearing can use the following procedures:

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29 In circumstances where the bonds are convertible only after the end of the distribution compliance period that otherwise would have applied, the applicable category can be determined solely by reference to the bonds. For example, if there is SUSMI in both the equity and debt of an issuer, an offering by that issuer of convertible bonds immediately convertible following their issuance would fall within Category 3. However, if the bonds were not convertible until after a year following the closing of the offering (or after six months in the case of an issuer current in its Securities Exchange Act reporting), the bonds could be offered under Category 2. *See* SEC Release No. 33-6863 (Apr. 24, 1990).

30 Similar problems have arisen, and the SEC staff has granted comparable no-action relief, in connection with the application of Category 3 restrictions in the context of non-reporting U.S. companies wishing to list their securities on foreign exchanges without also registering them in the United States. *See* European Association of Securities Dealers Automated Quotation N.V./S.A. (avail. July 1999); Australian Stock Exchange Limited (avail. Jan. 7, 2000); OM Stockholm Exchange (avail. Oct. 11, 2000); ISDM, Chapter 6.02[1]. It is not clear, however, that the procedures outlined in these letters still can be used, and it would be advisable to obtain either formal or informal guidance before relying on them. *See also* footnote 41 (discussing London Stock Exchange and SIS SegaInterSettle procedures to facilitate Category 3 offerings, and recent no-action relief in the context of a secondary listing by a U.S. issuer of depositary receipts on the Hong Kong Stock Exchange).

31 *See* Cravath, Swaine & Moore (avail. Aug. 26, 1998).

- the bond's CUSIP or other identification number must identify it as restricted, so that participants in the book-entry system recognize that transfers are restricted;

- if the issuer or managing underwriters provide information to publishers of publicly available databases about the terms of the bonds, the information must include a statement indicating that the securities have not been registered under the Securities Act and are subject to restrictions under Rule 144A and/or Regulation S;

- the offering memorandum must contain representations that are deemed to be made by purchasers in the offering regarding their non-U.S. status or other exempt status (*e.g.*, as QIBs under Rule 144A), and must contain agreements deemed to be made by purchasers regarding restrictions on resale and hedging; and

- any certificated securities, even in global form, issued prior to the expiration of the distribution compliance period must have an appropriate restrictive legend; after the distribution compliance period, the certificated securities must have a restrictive legend to the extent required by Rule 144;[32] and any definitive securities issued during the distribution compliance period (except in a transaction under Rule 144A) must satisfy the stop transfer requirements set forth in Rule 903(b)(3)(iii)(B)(4).[33]

These procedures relate only to the convertible bonds, and not to the underlying securities issued upon their conversion. It also is essential to ensure the availability of an exemption from registration for the conversion of the bonds into the underlying equity securities. Typically, Section 3(a)(9) will be available because the conversion will be into the equity securities of the bond issuer.[34] If Section 3(a)(9) is unavailable, additional steps will be required. If the underlying securities qualify for Category 1 treatment, in order to satisfy the offshore transaction requirement,

32 *See* footnote 28 (describing conforming amendments made to Regulation S following revisions to the holding period in Rule 144).

33 As an alternative to applying the *Cravath* letter procedures, convertible bonds can be offered on a global basis pursuant to Rule 144A, provided that non-U.S. investors are willing to accept the associated transfer restrictions (which are discussed below). Non-U.S. investors may qualify as QIBs, but it may be more difficult for them than U.S. investors because some elements of the definition can be satisfied only by U.S. entities. *See* "Rule 144A—Restricted Securities" below.

34 Section 3(a)(9) also is available where a parent issues its shares on conversion of a convertible bond (i) issued by a finance subsidiary or wholly owned operating company and guaranteed by the parent or (ii) issued by the parent and guaranteed by one or more such subsidiaries. *See* Section 3(a)(9) Upstream Guarantees (avail. Jan. 13, 2010).

bondholders should certify that they are outside the United States at the time of conversion. If the underlying securities qualify for Category 2 or 3 treatment, the bonds should be legended to indicate that neither they nor the underlying securities have been registered under the Securities Act and that the bonds may not be converted by or on behalf of U.S. persons except pursuant to such registration or an exemption therefrom. In order to convert, each person also should certify that it is not a U.S. person and that it is not converting on behalf of a U.S. person or provide a legal opinion that the bonds and underlying equity have been registered or that an exemption from registration is available. In addition, steps should be taken to protect against conversion of the bonds within the United States and delivery of the underlying securities there.

The Second Safe Harbor: Resales under Rule 904

The second safe harbor covers offshore resale of securities initially placed offshore or by private placement in the United States by persons other than the issuer, a distributor or any of their affiliates (except officers and directors that are affiliates merely by virtue of their position).[35] Such persons generally can resell their securities outside the United States immediately, provided the "offshore transaction" requirement is satisfied and directed selling efforts are not used in the United States.[36]

By contrast with the first safe harbor, where one way to satisfy the offshore transaction requirement is to execute the transaction in, on or through a physical trading floor of an established foreign securities exchange, the second safe harbor relies on the broader concept of the transaction being executed in, on or through the facilities of a "designated offshore securities market" and also requires that neither the seller nor anyone acting on its behalf know that the transaction has been pre-arranged with a buyer in the United States.[37]

[35] If the resale is by a director or officer who is an affiliate merely by virtue of his position, he may not pay a selling concession, fee or other remuneration in connection with the offer or sale, other than the usual and customary broker's commission that would be received by a person executing that sale as an agent. If these conditions are not met, a resale of the securities pursuant to Regulation S must be under Rule 903.

[36] If the resale is prior to the end of the distribution compliance period and is by a dealer or a person that received a selling concession, fee or other remuneration in respect of the securities, it also must not know that the buyer is a U.S. person and, if it knows the buyer is a dealer or a person receiving a selling concession, fee or other remuneration in respect of the securities, it must send a confirmation or other notice to such person indicating that the securities may be offered and sold during the distribution compliance period only in accordance with Regulation S or pursuant to registration under the Securities Act or an available exemption therefrom.

[37] *See* Rule 902(b)(1) for a list of some designated offshore securities markets and various SEC orders conferring this status on other exchanges.

Notwithstanding the availability of Rule 904, in practice, most resales of securities are covered by another exemption from registration, such as Section 4(a)(1), which provides an exemption for transactions by any person other than an issuer, underwriter or dealer. The safe harbor of Rule 904 generally is used only when the securities being offered or sold are restricted *or* when the seller is an officer or director of the issuer who is not otherwise affiliated with the issuer.[38] For example, QIBs that purchase securities pursuant to Rule 144A may resell the securities pursuant to Rule 904 during the Rule 144 restricted period.[39]

Resales into the United States

Resales Following a Rule 903 Offering. Aside from equity securities of U.S. issuers (discussed below), Regulation S does not explicitly address when securities placed offshore pursuant to the first safe harbor may be resold in the United States. However, the SEC staff has confirmed the generally held view that such securities, other than unsold allotment securities and equity securities of U.S. issuers, may be resold into the United States immediately, subject to the restrictions imposed on dealers by Section 4(a)(3), and those imposed on distributors and their affiliates under the applicable distribution compliance period in offerings subject to Category 2 or 3. Caution nonetheless may be appropriate in certain cases, as there is no safe harbor for such resales and a person falling within the definition of "underwriter" under Section 2(a)(11) of the Securities Act—a facts and circumstances-based determination—would not be entitled to rely on Section 4(a)(1).[40]

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38 There may be circumstances where neither Section 4(a)(1) nor Rule 904 is available—*e.g.*, because a designated offshore securities market is unavailable or the seller is an affiliate of the issuer (by virtue of more than just being an officer or director of the issuer). As suggested in footnote 14, the seller nonetheless may be able to sell its securities by relying on another exemption from registration, such as Rule 144. For example, a seller may wish to sell a stake of less than 1% in an issuer where a third party holds more than 10% of the voting equity in each of the seller and the issuer, thereby resulting in them being under common control (*i.e.*, making the seller an affiliate of the issuer). Moreover, in certain circumstances, a seller may be able to conclude that complying with the substance, but not the filing requirements, of Rule 144 (*i.e.*, its holding period, manner of sale and volume of sale restrictions) is sufficient for the sale not to require registration under the Securities Act (the theory being that Rule 144 is a non-exclusive safe harbor and that substantive compliance in these cases is sufficient to avoid triggering the registration requirements of the Securities Act).

39 As discussed in footnote 28, the SEC recently revised Rule 144 to allow non-affiliates to resell freely the securities of a Securities Exchange Act-reporting company six months after issuance, so long as the issuer continues to report. At the same time, the SEC made conforming amendments to Category 3.

40 The definition of "underwriter" in the Securities Act covers "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." *See* Section 2(a)(11) of the Securities Act. A "distribution" arises only where there is a "public offering" within the meaning of the Securities Act. Accordingly, if there is no public offering, there is no "distribution." However, the concept of a public offering is very much fact-dependent. Although the need for clarity in this context gave rise to Regulation D and similar safe harbors, as noted above, the SEC has not promulgated a safe harbor specifically for resales following Regulation S sales.

Rule 905 of Regulation S explicitly treats equity securities of U.S. issuers placed pursuant to the first safe harbor as "restricted securities," as defined in Rule 144 (discussed further below), even if they are resold pursuant to Rule 904 (as discussed further below). This rule was added in 1998 to provide investors with clarity about permissible resales in this context. Thus, once the one-year (or six-month, in the case of a current reporting issuer) distribution compliance period has ended, limited resales pursuant to Rule 144 should be permissible, with unlimited resales becoming possible for non-affiliates after one year (or six months in the case of a current reporting issuer). Compliance with Rule 905 may result in practical difficulties for an issuer, as Section 4(a)(2) procedures, such as legending, should be applied during the restricted period; these procedures may pose problems with the listing requirements of non-U.S. markets, which may not accept legended, certificated securities.[41]

Resales Following a Rule 904 Resale. In adopting Rule 905, the SEC made clear that the resale of restricted securities (*e.g.*, equity securities of a domestic issuer placed pursuant to Regulation S) under Rule 904 would not "wash off" the restricted status of the securities and thereby allow them to be freely resold into the United States by the purchaser. However, the SEC also noted that it was taking a targeted approach to addressing the abuses prompting the 1998 amendments to Regulation S and declined to extend Rule 905 to the securities of foreign private issuers.[42]

41 In 2006, the London Stock Exchange issued a notice in relation to the settlement of securities issued under Category 3 on the Alternative Investments Market of the London Stock Exchange ("AIM") and then adopted rule amendments in line with the notice. SIS SegaInterSettle AG, an electronic settlement system operator based in Switzerland, also provides an electronic settlement service with characteristics to enhance the ability of issuers to comply with restrictions imposed under Regulation S. Some questions remain as to the adequacy of these procedures, but a full discussion of this topic is beyond the scope of this article. For further discussion, *see* London Stock Exchange AIM Notice AIM19: Settlement of AIM Reg S Securities and SIS (May 26, 2006); London Stock Exchange Notice N44/06: Confirmation of Rule Amendments, Reg S Traded Securities and SIS (July 28, 2006); London Stock Exchange Rule 1550. *See also* Coach, Inc. and J.P. Morgan Chase Bank N.A. (avail. Nov. 28, 2011) (granting relief from certain aspects of Regulation S in connection with a secondary listing on the Hong Kong Stock Exchange of depositary receipts representing Coach common stock).

42 The adopting release for the 1998 amendments states: "By not extending Rule 905 to securities of foreign private issuers, the principal concerns of the commenters in this respect should be addressed. Although some commenters have expressed concern that the certification and legending requirements may hinder free trading on offshore securities markets, without these requirements the potential for easy evasion of Rule 144's resale limitations for domestic equity securities is high." *See* SEC Release No. 33-7505 (Feb. 17, 1998) (footnote omitted). The release made it clear that securities other than equity securities of domestic issuers will not be restricted (and thus will not be subject to Rule 144 resale limitations) once sold offshore: "[B]ecause of its limited scope there should be no basis for a concern that Rule 905 could restrict the ability of a foreign security that was privately placed in the United States to be sold back into its home market offshore in a Rule 904 or Rule 144A transaction." *See* SEC Release No. 33-7505 (Feb. 17, 1998), note 34. The SEC indicated, however, that it would continue to monitor for abusive practices in the context of equity offerings by foreign issuers, particularly where their principal trading market is the United States. *See* the discussion of Category 2½ below.

Accordingly, once resold outside the United States, securities other than equity securities of domestic issuers are unrestricted and generally can be freely resold, including into the United States.

Regulation S / U.S. Public Offerings

Issuers sometimes carry out U.S. public offerings alongside offshore offerings pursuant to Regulation S. In this context, a foreign private issuer and underwriters may wish to register under the Securities Act some of the securities they anticipate selling outside the United States, because it may be difficult to assess offshore demand with complete accuracy at the time the registration statement is filed in the United States. Registering 10% to 15% of the anticipated non-U.S. portion provides flexibility in this respect. A larger portion, if not all, of the non-U.S. portion typically would be registered if the issuer expected its principal trading market to be the United States. A U.S. issuer generally would register the whole non-U.S. portion in light of the practical difficulties presented by Rule 905, as discussed above. In addition, to the extent securities in the offshore tranche are registered, dealers buying such securities will be able to resell them freely in the United States during the Section 4(a)(3) prospectus delivery period.

Voluntary Compliance with Stricter Requirements: Prudential Category 2 and Category 2½

Two circumstances have emerged in which issuers and underwriters voluntarily adhere to more stringent requirements under Regulation S than otherwise would apply under the regulation.

Prudential Category 2

The first instance of voluntary adherence to stricter-than-necessary requirements is commonly referred to as "prudential Category 2," and refers simply to the use, as a matter of prudence, of (all or a portion of) the Category 2 restrictions in offerings that otherwise would qualify for Category 1. Some practitioners have embraced this approach, apparently with a view to the 40-day period referred to in Section 4(a)(3) and, more significantly, based on the idea that the policy underlying Regulation S is furthered by adherence to a stricter regime than the offering requires. In the 1990s, prudential Category 2 was particularly popular, with some firms requiring prudential Category 2 as a condition to issuing a no-registration opinion in Regulation S / Rule 144A transactions. Presently, the approach has fallen out of favor for equity offerings of European issuers, but it remains common in the Latin American market.

We do not believe that prudential Category 2 is justified: Section 4(a)(3) is a distinct provision that should not be conflated with Regulation S. Moreover, prudential Category 2 effectively wipes Category 1 off the books—a step we do not believe the SEC sought when it crafted the three categories.

Category 2½

As the name suggests, Category 2½ refers to a set of restrictions that contains certain elements of Categories 2 and 3. This blend of categories has been applied to equity offerings by foreign private issuers that are eligible for Category 2, but where the United States is the sole trading market for the securities offered or where U.S. trading volume comprises a very large percentage (*e.g.*, 90% or more) of worldwide trading volume. In these contexts, market participants sometimes have concluded that some of the concerns underlying the more stringent restrictions of Category 3 may be relevant. These conclusions reflect in part the SEC's proposal to subject to Category 3 all offerings by foreign private issuers with securities having more than half their trading on U.S. exchanges.[43] Although the SEC did not adopt this proposal after many strongly objected to it, the SEC noted that it would continue to monitor this area for abuses. Accordingly, in these circumstances, issuers sometimes have applied modifications to the Category 3 procedures described above to stem the flowback of the securities into the United States. The procedures are applied for 40 days (rather than one year or six months) and may include steps such as requiring investors to certify that they have not engaged in hedging activities relating to the securities in anticipation of the offering or during the distribution compliance period, as well as implementing other aspects of Category 3 restrictions.

The TEFRA Rules[44]

Overview

It is customary in some non-U.S. jurisdictions to issue bonds that are represented by a global bearer note. The note typically is held by a common depositary on behalf of the clearing organizations through which investors hold their interests. European bond offerings historically also have made certificated securities in bearer form available to investors. More recently, bonds have also been issued

43 SEC Release No. 33-7392 (Feb. 20, 1997).

44 The authors would like to thank Messrs. James Duncan, William McRae and Daniel Pilarski of Cleary Gottlieb Steen & Hamilton LLP (and Mr. Ed Saad, formerly of the firm) for their assistance with the discussion of tax matters herein.

through dematerialized book-entry systems. In such systems, bonds are required to be represented only by book entries, and no physical certificates are issued or transferred.

Even though it has become increasingly uncommon as the capital markets have developed for investors ever to hold certificated bearer notes, standard European global bond documentation typically still provides for the availability of certificated bearer securities. Debt instruments with this feature generally will be treated as bearer instruments for U.S. tax purposes. The availability of certificated bearer securities historically has been a source of concern to the U.S. tax authorities, given their potential to facilitate U.S. tax evasion and money laundering. The TEFRA anti-bearer bond rules thus impose substantial restrictions on issuances of debt instruments (including convertible and exchangeable bonds) that are treated as bearer securities for U.S. tax purposes. These restrictions are intended to make it economically impracticable for an issuer to issue bearer debt securities, with a narrow exception for non-U.S. issuers that comply with certain specified requirements designed to ensure that the debt instruments are not sold into the United States.

Book-Entry Registration Arrangements for Non-U.S. Issuers

Fortunately, most non-U.S. issuers of bearer bonds can avoid the application of the TEFRA rules by structuring their global bond offerings in a manner that satisfies any non-U.S. market preference for bearer securities while nevertheless causing the bonds to qualify as being in registered form for U.S. tax purposes. Bonds that are considered to be in *registered form* for U.S. tax purposes are not subject to the TEFRA sales restrictions and certification requirements.

Bonds represented by a physical global bearer note nonetheless will be considered registered securities for U.S. tax purposes so long as:

- the global note is held throughout its term by a depositary acting as an agent for a clearing organization for the benefit of purchasers of interests in the obligation under arrangements that prohibit the transfer of the global note, except to a successor depositary subject to the same terms; and

- the depositary maintains a book-entry system recording the ownership of interests in the global note on the issuer’s behalf, and beneficial interests in the underlying bonds are transferable only through the book-entry system, except that holders may obtain physical certificates in bearer form in the following circumstances:

    (1) termination of the depositary’s business without a successor;

(2) default by the issuer; or

(3) upon a change in tax law that would be adverse to the issuer but for the issuance of physical securities in bearer form.[45]

The difference between the local market's view of what constitutes a bearer instrument (which depends principally on the designation of the instrument as a bearer bond) and the technical U.S. tax definition (which depends on the manner in which an interest in the instrument may be transferred) makes it possible to structure bonds that are considered to be in bearer form from a non-U.S. perspective but nevertheless qualify as registered obligations for TEFRA purposes.

Bonds that are issued through a dematerialized book-entry system and that are not represented by a physical security will be considered registered securities for U.S. tax purposes so long as beneficial interests in the bonds are transferable only through a book-entry system that identifies the owner of beneficial interests in the bonds, and that is maintained by a clearing organization or a depositary acting as an agent for a clearing organization.

In international bearer bond offerings by non-U.S. issuers, especially where U.S. demand is anticipated from the outset, depositary banks frequently enter into book-entry registration agreements with the issuer. The depositary holds the global note in a manner that causes the bonds to qualify as registered obligations for U.S. tax purposes.[46] Even when an international bond offering is not thought to be of interest to U.S. investors, the use of book-entry arrangements can produce significant benefits and normally will have no substantial costs or consequences.[47]

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[45] In the event that local law and market preferences require that a global bond offering provide for the availability of certificated securities to investors in circumstances other than those described in the three narrow exceptions, it typically is possible to satisfy this requirement by providing for the availability of registered (as opposed to bearer) certificated securities in those circumstances. Moreover, because depositaries generally maintain a book-entry system recording the ownership of the global note on behalf of the clearing organizations, they generally are willing to agree to maintain those same records on behalf of the issuer (and the clearing organizations typically permit them to do so).

[46] These book-entry registration arrangements often are referred to as "Barclays structures" in light of the fact that Barclays was one of the first institutions to use this type of structure.

[47] There may continue to be circumstances in which the arrangements do not make sense in the context of a particular offering, but we believe that they will represent a very small proportion of international bond offerings. Following the adoption of standardized documentation, the only such circumstances that we can envisage are (i) where the documentation of an existing facility immutably requires that certificated securities be made available in definitive bearer form or (ii) the offering is targeted to one of the few remaining markets where local market practice requires that definitive bearer securities be made available.

The widespread adoption of standardized book-entry arrangements—ideally, as the default choice—would enhance flexibility, facilitate compliance with U.S. tax rules and reduce administrative burdens and legal risks on issuers and underwriters. It also would reduce the apparent complexity of book-entry arrangements, thereby facilitating the issuance of bonds that are in registered form for U.S. tax purposes while respecting the frequent European market preference for bearer instruments. Of course, if the issuer is able to issue bonds (including convertible or exchangeable bonds) in registered form, it can avoid TEFRA compliance concerns by doing so.

TEFRA Rules for Non-U.S. Issuers

If a non-U.S. issuer of bonds (including convertible or exchangeable bonds) is unable or unwilling to issue the bonds in registered form or in accordance with the book-entry system described above, the bearer bonds will generally be treated as bearer-form securities for U.S. tax purposes. In order to avoid adverse U.S. tax consequences, the bonds must be issued in accordance with certain restrictions:[48]

- *Arrangements reasonably designed*. The TEFRA rules require that issuers and dealers offer and sell bearer obligations pursuant to arrangements that are reasonably designed to ensure that the obligations are sold (or resold in connection with the initial offering) only to non-U.S. persons, in accordance with one of two sets of rules, the TEFRA D rules or the TEFRA C rules, which are discussed below.

- *No interest payments in the United States.* Interest on bearer obligations must be payable only outside the United States and its possessions. This requirement will be satisfied if interest is payable only upon presentation of a coupon, or a demand for payment, outside the United States and its possessions. Subject to certain exceptions, interest payments also may not be made by transfer of funds into the United States or its possessions, including by mail.

- *Legend.* Bearer obligations, including any bearer coupons, generally must bear a legend on their face, which indicates that any U.S. person that holds them is subject to certain restrictions under U.S. tax laws.[49]

48 The TEFRA restrictions do not apply to debt securities with a maturity of one year or less.

49 U.S. persons generally are permitted to hold bearer debt securities issued on or before March 18, 2012 only if they hold the securities through appropriate custodial arrangements with financial institutions whereby (i) income derived from the securities is reported to the Internal Revenue Service and (ii) restrictions are placed on the resale of the securities to other U.S. persons. For debt securities issued after March 18, 2012, or for U.S. holders that fail to comply with the restrictions described above, U.S. holders generally will not be permitted to (i) deduct losses realized on any disposition of the securities or (ii) treat any gain realized on any disposition of the securities as capital gain.

The penalties that may be imposed on an issuer for its or a dealer's failure to comply with these rules can be severe:

- issuers may be liable for U.S. excise tax equal to 1% of the principal amount of the non-compliant obligations, multiplied by the number of years from the issue date to maturity; and

- interest on the non-compliant bearer obligations generally will not be (i) deductible for U.S. tax purposes or (ii) exempt from 30% U.S. withholding as portfolio interest (in the case of U.S. issuers, including U.S. branches of non-U.S. issuers).

In 2010, Congress repealed the exceptions from TEFRA for bearer debt securities of a U.S. issuer. Accordingly, a U.S. issuer of bearer debt securities issued after March 18, 2012, and a U.S. holder of such debt securities, will be subject to the harsh U.S. tax consequences described above regardless of whether the issuer complies with the TEFRA restrictions.

TEFRA D

TEFRA D generally prohibits issuers and distributors of bearer obligations from offering or selling those obligations to U.S. persons or any persons within the United States or its possessions during a restricted period that begins on the earlier of the first date on which the obligation is offered to persons other than distributors and the closing date, and generally ends 40 days after the closing date (except in respect of unsold allotment securities, with respect to which the restricted period ends when those securities are sold by the relevant distributor, if after the 40-day period).[50]

These restrictions go *beyond* the territorial restrictions of Regulation S by applying the anti-bearer bond restrictions described above to U.S. persons worldwide. That is, even where Regulation S would allow the solicitation of *U.S. persons outside the United States* (*i.e.*, in a Category 1 offering), TEFRA D would prohibit it.[51]

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50 In addition to imposing restrictions on offering participant activity, TEFRA D, subject to certain narrow exceptions, also requires relevant clearing organizations and their members to certify to the issuer, on the earlier of the date of the first actual payment of interest by the issuer or the date that the issuer delivers an obligation in definitive form to the depositary, that the beneficial owners of the bearer obligations as of that date are non-U.S. persons or persons eligible to hold the obligations pursuant to the exceptions described above. These blanket TEFRA D certifications can be a significant burden to the clearing organizations and their members.

51 TEFRA D does provide a safe harbor that generally protects an issuer from sanctions if a distributor inadvertently sells bearer obligations to a U.S. person. The safe harbor applies only if the distributor agrees to comply with the TEFRA D rules and has procedures in place to ensure that its sales force is aware of the relevant restrictions. When TEFRA D is being followed, it is standard for distributors to agree to comply with the TEFRA D rules, and to represent that they have implemented such procedures, in the purchase agreement for the bonds.

Moreover, TEFRA D prohibits certain offers and sales to persons *within the United States* that are not prohibited by Regulation S. For example, even if an offering is not structured to permit U.S. sales under Rule 144A, Regulation S nonetheless generally permits offers and sales to be made to U.S. fiduciaries acting on a discretionary basis for the benefit or account of non-U.S. persons. TEFRA D, however, does not.[52] The mismatch between Regulation S and TEFRA D creates significant potential for misunderstandings and complications, particularly in Regulation S-only offerings with little connection to the United States.

TEFRA C

The TEFRA C rules provide an alternative, and potentially less burdensome, means of complying with TEFRA's general "arrangements reasonably designed" requirement. Unlike TEFRA D, however, TEFRA C does not provide a safe harbor, and therefore generally provides substantially less comfort than TEFRA D. In order to satisfy the TEFRA C rules, the bearer obligations must be issued only outside the United States and its possessions, and the issuer must not engage significantly in interstate commerce, directly or indirectly, in connection with the offering. Interstate commerce is defined very broadly for this purpose to include trade or commerce in obligations or any related transportation or communication between any foreign country and the United States or its possessions. TEFRA C therefore prohibits, among other things, negotiations or communications between a prospective purchaser and the issuer or its agent, or any dealer or member of the selling group, if either of them is within the United States or its possessions. The rules also prohibit the involvement in the offering of the U.S. offices of the issuer or dealers, as well as the delivery or advertisement of the bonds in the United States or its possessions.

Non-U.S. issuers generally cannot rely on TEFRA C in the context of simultaneous Regulation S and U.S. private placements. Moreover, in light of TEFRA C not providing a safe harbor, and despite TEFRA C's apparent administrative simplicity, most issuers choose to rely on the TEFRA D rules. Non-U.S. issuers typically rely on the TEFRA C rules only when the bearer obligations are (i) denominated in a currency (or currencies) other than the U.S. dollar and (ii)

52 A dealer that is not a party to the purchase agreement (and is not otherwise a member of the selling group) can sell bonds in the secondary market to U.S. fiduciaries acting for non-U.S. customers, and possibly also to certain U.S. institutional investors, without violating the TEFRA rules.

The TEFRA D rules also generally allow bearer obligations to be placed with (i) U.S. distributors buying the bonds for resale; (ii) non-U.S. branches of U.S. financial institutions buying for their own account or resale; and (iii) subject to certain conditions, U.S. persons who buy through a non-U.S. branch of a U.S. financial institution and hold the bonds through that financial institution, where the institution has agreed to comply with certain U.S. information reporting requirements.

being sold to a relatively small number of non-U.S. investors buying for their own account outside the United States.

Rule 144A[53]

Regulation S offerings, whether public or private in the issuer's home jurisdiction or elsewhere outside the United States, often feature a concurrent private placement in the United States pursuant to Rule 144A.[54] Rule 144A allows such issuers to tap the deep institutional investor base in the United States, while avoiding the time constraints and regulatory demands of SEC review.

The policy underlying the rule is that sophisticated institutions do not need the protections afforded by the Securities Act registration process. Securities sold in accordance with the rule's terms will not be considered distributions or to involve a public offering. However, securities acquired under Rule 144A are "restricted securities" as defined in Rule 144 and subject to limitations on their public resale, as discussed further below.

Conditions

The availability of Rule 144A turns on several conditions being met:

- *Qualified Institutional Buyers.* The seller must reasonably believe that the purchaser is a "qualified institutional buyer" (commonly known as a "QIB"). To qualify, an institution generally must own or invest on a discretionary basis at least $100 million of securities and be an institution falling within a list of specified types (which includes corporations, insurance companies, registered investment advisers, registered investment companies, employee benefit plans, broker-dealers and banks, among others).

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53 The discussion of Rule 144A herein is drawn largely from Chapter 5 of the ISDM.

54 Of course, Rule 144A is not the only exemption from Securities Act registration that may be used to effect a private placement in the United States. However, it is the most common and the most flexible from a procedural standpoint. If Rule 144A is not available, consideration should be given to relying on Regulation D or Section 4(1½). *See* ISDM, Chapter 5; Peter Castellon, *Another Way In*, XXXI IFLR, No. 2 (Mar. 2012).

In the context of offerings by companies that are "investment companies" within the meaning of the Investment Company Act of 1940, as amended, extensive additional selling and transfer restrictions apply. A discussion of these is beyond the scope of this article. *See* ISDM, Chapter 18; Barry P. Barbash, John E. Baumgardner, Jr., Robin M. Bergen, William G. Farrar, Maria R. Gattuso and Nathan J. Greene et al., *Investment Company Act Status of Non-U.S. Issuers*, 19 Inv. Lawyer, No. 4 (Mar. 2012).

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- *Notice.* The seller and any person acting on its behalf must take reasonable steps to ensure that the purchaser is aware that the seller may be relying on Rule 144A. Typically, such steps would include a statement to this effect in the offering memorandum, as well as the sale confirmation.

- *Fungibility.* The securities, *when issued,*[55] cannot have been of the same class as securities listed on a U.S. securities exchange or quoted in a U.S. automated inter-dealer quotation system. Securities convertible or exchangeable into securities so listed or quoted at the time of issuance that have an effective conversion premium of less than 10% are considered securities of the class into which they are convertible or exchangeable for this purpose.

- *Information.* The issuer must be a Securities Exchange Act-reporting company or exempt from reporting under Rule 12g3-2(b) under the Securities Exchange Act. Otherwise, it must agree to provide certain financial and other information upon request to holders and prospective holders of the securities.

- *No general solicitation or general advertising.* Like the Regulation S prohibition on directed selling efforts, publicity activities in the form of general solicitation or general advertising historically were prohibited in the context of a Rule 144A offering,[56] and market participants relied on safe harbors under Rule 135c and Rule 135e to permit certain limited press-related activity, and Rules 138 and 139 to allow the distribution of certain types of research reports.[57]

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55 Securities issued prior to when securities of that class are listed—commonly referred to as "founders' shares"—should be eligible for Rule 144A so long as they can be identified specifically.

Securities underlying convertible securities originally issued under Rule 144A also are eligible for resale under Rule 144A so long as no additional consideration is paid by the holder in connection with the conversion. *See* Debevoise & Plimpton (avail. July 23, 1990).

56 Soliciting QIBs in Rule 144A placements does not constitute directed selling efforts for purposes of Regulation S.

57 In the context of Category 3 / Rule 144A placements, issuers not wishing to be constrained by the information limits of Rule 135c, but ineligible to rely on Rule 135e as a result of their domestic status, sometimes historically adhered to so-called "Rule 135e(½)." Under this approach, press materials were released only offshore (in keeping with Rule 135e), but underwriters were not named (in keeping with Rule 135c). A legend indicating that the materials were not an offer of the securities in the United States also was included (in keeping with both rules). To the extent any offshore press conferences were held, U.S. journalists were excluded (in contrast to Rule 135e) in order to minimize any nexus with the United States. Although not a formal safe harbor, practitioners concluded in certain circumstances that following these procedures should prevent the press

However, the JOBS Act, enacted in April 2012, directed the SEC to amend Rule 144A within 90 days of enactment to permit securities sold under Rule 144A to be offered to persons other than QIBs, including by means of general solicitation or general advertising, provided that only QIBs (or persons the seller, or any person acting on the seller's behalf, reasonably believe to be QIBs) purchase the securities.[58]

Restricted Securities

Securities sold under Rule 144A are "restricted securities" (as defined in Rule 144). They cannot be resold publicly with the benefit of the Rule 144 safe harbor for public resales of privately placed securities until the applicable conditions of that rule are satisfied (*e.g.*, the six-month or one-year holding period relating to resale without restrictions by non-affiliates).[59] Accordingly, until those conditions are met, resales of the securities must be limited or carried out pursuant to Regulation S.

Rule 144A does not require purchasers to sign any documentation under which they agree to adhere to applicable transfer restrictions. QIBs are considered sophisticated and capable of self-policing.

Offering memoranda typically will contain deemed representations under which QIBs are considered, merely by virtue of purchasing the securities, to have represented and agreed that they satisfy the conditions for purchasing the securities initially and that they will comply with applicable transfer restrictions on reselling

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materials or activities from constituting directed selling efforts or general solicitation. *See* Peter Castellon and Sara Hanks, *How to Use 135e*, XXVII IFLR, No. 3 (Mar. 2008).

58 The legislation contains a similar direction in respect of offerings under Rule 506 of Regulation D (relating to private placements to "accredited investors"). It does not, however, affect other private offerings, such as private placements under other Regulation D exemptions or Section 4(a)(2) of the Securities Act (outside the Rule 506 safe harbor).

The JOBS Act also did not change the prohibition on directed selling efforts in Regulation S offerings. The SEC staff has indicated informally, however, that the liberalization introduced by the act should not render unavailable the long-standing guidance in the Regulation S adopting release to the effect that "[o]ffshore transactions made in compliance with Regulation S will not be integrated with registered domestic offerings or domestic offerings that satisfy the requirements for an exemption from registration under the Securities Act, even if undertaken contemporaneously." *See* SEC Release No. 33-6863 (Apr. 24, 1990). If the principle articulated by the guidance remains applicable, general solicitation in the context of the Rule 144A portion of a Regulation S / 144A offering should not constitute directed selling efforts that would undermine the availability of Regulation S in respect of the offshore portion. In any event, the SEC is expected to propose rules implementing Section 201(a) in the near term, which could well address this issue.

59 *See* footnote 28 discussing the recent revisions to Rule 144, which, among other things, substantially shortened the holding periods for restricted securities.

them.[60] In particular, the purchaser typically will be deemed to agree on its own behalf and on behalf of any investor account for which it is purchasing the securities, and each subsequent holder of the securities will be deemed to agree, to offer, sell or otherwise transfer the securities so long as they are restricted under Rule 144 only:

- to the issuer or any of its subsidiaries;
- pursuant to a registration statement that has been declared effective under the Securities Act;
- to a person it reasonably believes is a QIB that purchases for its own account or for the account of a QIB to whom notice is given that the transfer is being made in reliance on Rule 144A;
- in an offshore transaction in accordance with Regulation S; or
- pursuant to another available exemption from the registration requirements of the Securities Act, subject to the right of the issuer (and, in the case of a debt offering, the trustee) to require the delivery of an opinion of counsel, certifications and/or other information satisfactory to the issuer (and the trustee).

As these restrictions indicate, shares acquired under Rule 144A may be resold offshore in compliance with Regulation S and generally will no longer be restricted once resold outside the United States.[61]

Conclusion

It is important to revisit Regulation S and Rule 144A at the outset of any offering relying on these safe harbors in order to ensure that the correct selling and transfer restrictions are applied. Failure to correctly implement these restrictions can have deleterious effects in the purchase agreement and the offering memorandum, as well as in connection with permissible publicity activities, and result in significant violations of law, potentially compromising the entire offering.

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60 Although Rule 144A(d)(2) requires that the seller and any person acting on its behalf take reasonable steps to ensure that the buyer is aware that the seller may rely on Rule 144A, there is no requirement to include these deemed representations. They are, however, frequently applied in practice.

61 As discussed above, under Rule 905 of Regulation S, equity securities of U.S. issuers sold pursuant to Regulation S will continue to be restricted notwithstanding their resale under Rule 904.

Appendix A

Overview of Regulation S by Category

Formal Categories

Category 1	**Category 2**	**Category 3**
• Equity securities of a foreign private issuer ("FPI"), ***if*** there is ***no*** SUSMI in that ***class*** of equity • Debt securities of an FPI, ***if*** there is ***no*** SUSMI in the issuer's ***total*** debt securities	• Equity securities of a ***reporting*** FPI, ***if*** there is SUSMI in that **class** of equity • Debt securities of a ***reporting*** FPI, ***if*** there is SUSMI in the issuer's ***total*** debt securities • Debt securities of a ***non-reporting*** FPI, ***if*** there is SUSMI in the issuer's ***total*** debt securities • Debt securities of a ***reporting*** U.S. issuer	• Equity securities of ***non-reporting*** FPI, ***if*** there is SUSMI in that **class** of equity • Equity securities of a ***reporting*** U.S. issuer • Equity securities of a ***non-reporting*** U.S. issuer • Debt securities of a ***non-reporting*** U.S. issuer

Informal Categories

Category 0	**Prudential Category 2***	**Category 2½**
• Equity securities of non-reporting FPI without SUSMI in that **class** of equity	• Equity securities of an FPI, if offered concurrently with a Rule 144A offering • Equity securities of a reporting FPI • Debt securities of an FPI	• Equity securities of a reporting FPI, ***if*** there is SUSMI in that **class** of equity ***and if*** a very large percentage (*e.g.*, 90% or more) of its trading volume is in the United States

* Prudential Category 2 refers simply to the use, as a matter of prudence, of (all or a portion of) the Category 2 restrictions in offerings that otherwise would qualify for Category 1. Practice varies as to its application, with the most extreme implementation being its use in all offerings that otherwise would qualify for Category 1 treatment. Here, however, we have highlighted some of the more common cases where prudential Category 2 has been applied on a more selective basis. We do not believe that prudential Category 2 is justified.

Overview of Regulation S by Characteristics

Debt vs. Equity

Debt	Reporting	Non-Reporting
FPI without SUSMI	1	1
FPI with SUSMI	2	2
U.S. Issuer	2	3
Equity	**Reporting**	**Non-Reporting**
FPI without SUSMI	1	1*
FPI with SUSMI	2†	3
U.S. Issuer	3	3

Reporting vs. Non-reporting

Reporting	Debt	Equity
FPI without SUSMI	1	1
FPI with SUSMI	2	2†
U.S. Issuer	2	3
Non-Reporting	**Debt**	**Equity**
FPI without SUSMI	1	1*
FPI with SUSMI	2	3
U.S. Issuer	3	3

U.S. Issuer vs. FPI

FPI without SUSMI	Debt	Equity
Reporting.............................	1	1
Non-Reporting	1	1*
FPI with SUSMI	**Debt**	**Equity**
Reporting.............................	2	2†
Non-Reporting	2	3
U.S. Issuer	**Debt**	**Equity**
Reporting.............................	2	3
Non-Reporting	3	3

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* Part of the subset of Category 1 sometimes known as Category 0.

† In certain circumstances, Category 2½.

<u>Key Restrictions under Regulation S Categories</u>

Category 1	**Category 2**	**Category 3 Debt**	**Category 3 Equity**
• Offshore transaction • No directed selling efforts	• Offshore transaction • No directed selling efforts • Offering restrictions • 40-day distribution compliance period • Notice to distributors	• Offshore transaction • No directed selling efforts • Offering restrictions • 40-day distribution compliance period • Notice to distributors • Temporary global note	• Offshore transaction • No directed selling efforts • Offering restrictions • 6-month to 1-year distribution compliance period • Notice to distributors • Investor certification of non-U.S. person status • Purchaser agreement on resales and hedging • Transfer refusal procedures • Legend (for domestic issuers only)

Category 0	**Prudential Cat. 2**	**Category 2½**
• Offshore transaction • No directed selling efforts	• Offshore transaction • No directed selling efforts • Offering restrictions • 40-day distribution compliance period • Notice to distributors	• Offshore transaction • No directed selling efforts • Offering restrictions • 40-day distribution compliance period • Notice to distributors • Investor certification of non-U.S. person status • Purchaser agreement on resales and hedging • Transfer refusal procedures

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