United States Senate
Committee on Homeland Security and Governmental Affairs
Permanent Subcommittee on Investigations

9:00 a.m., Tuesday, August 1, 2006 - Dirksen 106

Hearing on

"Offshore Abuses: The Enablers, the Tools and Offshore Secrecy"

Prepared Statement/Testimony
of
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Opening Remarks

Chairman Coleman, Ranking Member Levin, and Members of the Subcommittee – thank you for the invitation to share my thoughts on certain United States federal securities law implications of certain aspects of your ongoing investigation into abusive tax shelters and tax havens. I have prepared detailed written testimony that addresses several of the underlying securities law concepts that appear to be at issue in certain of the transactions under investigation. I also have brief opening remarks, during which I intend only to highlight the more important aspects of my prepared testimony. I would respectfully request that the full text of my written testimony be entered into the record of this hearing.

The United States federal securities laws are based upon the principle of full disclosure. The disclosure that is required by those laws comes in many forms – information that is required when a company is selling securities; information about the persons seeking to acquire ownership of U.S. public companies and information about the officers, directors and significant shareholders of U.S. public companies. To the extent that the information that is required to be disclosed by U.S. federal securities laws is complete and accurate, the investing public has information with which to make an investment decision. Thus comes the most important by-

product of complete and accurate information – trust. Without trust in the underlying information that is disclosed about companies, the markets simply will not function – or will do so in a very imperfect manner.

We have all seen what happens when the investing public loses trust in the financial marketplace. Think – Enron, WorldCom, Tyco, Global Crossing and the list that could go on and on. Indeed, one of the purposes of the Sarbanes-Oxley Act of 2002 was to attempt to restore the public trust in the marketplace – to make financial statements of public companies are transparent and reliable. But there is much more to transparency and to what is required to and should be disclosed by companies offering securities in the United States. Some of those requirements and their importance to the investing public are discussed in detail in my written testimony. Concerns that these requirements are meant to address include:

- Purported "private placements" of securities by U.S. companies to purportedly independent off-shore entities that, in fact, are controlled by promoters or affiliates of the U.S. company issuing the securities. Promoters have used these off-shore vehicles to trade illegally in their own stocks, to engage in a practice known as "painting the tape" – generating fictitious trades to drive up stock prices. These securities are then resold to U.S. investors without full disclosure – these types of actions strike at the heart of the purpose of, and indeed, in some cases, violate the Securities Act of 1933.

- Concentration of share ownership in U.S. public companies by affiliated groups that exceeds reporting thresholds imposed by the Securities Exchange Act of 1934. These prevent the companies in question from determining the identities of large beneficial owners and can give the appearance of greater liquidity, in the way of public float, in the market for the security in question.

To the extent that overseas companies are used to shield information that is difficult to discern even with domestic entities, the use of off-shore entities in so-called "secrecy" jurisdictions, without question, exacerbates the issue of lack of transparency in the U.S. securities markets. From all appearances, it is becoming increasingly commonplace to find an off-shore connection in cases of security fraud. In the late 1990's, A.R. Baron & Co. and 13 of its former officers and employees were convicted in New York for running an organized criminal enterprise. Baron was what is often referred to as a "boiler room," pushing questionable stocks to investors – their investors lost more than $75 million over a 5 year period. In the Baron case, Liberian shell companies and accounts in the Isle of Jersey were used to trade in the stock that Baron was underwriting, a violation of U.S. securities laws. Illegal profits were sheltered – from tax authorities and creditors – in a Cook Islands trust. A New York attorney prepared the trust documents and a so-called "protector" of the trust, located in New York, managed the trusts affairs. The "protector" was one of the defendants' fathers. The Cook Island trustee did business in New York through one of the largest banks in Australia, which is reported to have refused to honor a New York subpoena on the grounds that to do so would violate Cook Islands bank secrecy laws.

I venture to say that the principal attraction of doing business in off-shore havens is not tax rates. The "benefits" that are almost always present in many of these jurisdictions are: strict bank and corporate secrecy, lack of transparency in financial dealings and the lack of any meaningful regulation or supervision in the financial services area. The lack of transparency and the strict secrecy is particularly troublesome because it prevents regulators from, among other things, determining true beneficial ownership of off-shore entities (particularly when ownership sometimes is evidenced only by "bearer" instruments).

Numerous internet websites solicit applications to open bank accounts, purchase shell companies or even establish personal banks off-shore; many take applications by e-mail. According to one web page, 100,000 American millionaires have "disappeared" (*i.e.*, moved off-shore) because "hugely profitable investments are being hidden from you by a cartel of lawyers, regulators and Wall Street special interests." The site then says "Click here for details." This website illustrates how easy it is today to take advantage of (or to be taken advantage of by) off-shore venues.

It has been said that the absence of responsible supervision in off-shore jurisdictions also encourages financial institutions to engage in reckless behavior which, as the near-collapse of Long Term Capital taught us, could result in disastrous consequences for our domestic financial institutions and the economy if regulators do not do something to control such activities. Those promoting "tax products" are not above attempting to avoid compliance with securities laws. Some ten plus years ago, I personally was involved in a transaction that resulted in significant cash distributions to the shareholders of a U.S. public company. One shareholder, who also was the company's founder and a director, received more than $100 million. Following announcement of the transaction, this gentleman had stated publicly that he had great confidence in the company and did not intend to "sell a single share" of his stock in the company. He was approached by investment advisors, however, who were promoting a tax scheme by which he could avoid payment of the taxes through transfers of the shares to off-shore entities for a brief period of time. When asked if the validity of the tax scheme was dependent upon the transaction being a "true sale" of the securities, the bankers stated that it did. The shareholder was advised that he would, as required by U.S. securities laws, be required to report the "sale," and to consider how that would be consistent with his statement that he would not sell a single share and whether the reacquisition of the shares would generate potential liability under section 16 of the Securities Exchange Act of 1934. The bankers promoting the transaction, however, objected to the shareholder reporting the sale, pointing out that the securities were going to be immediately (same day) returned to the shareholder. This particular gentleman understood the consequences of what was being discussed and elected to forego the tax scheme and pay his taxes. This, however, like the more detailed example in my written testimony with respect to prepaid variable forward contracts, points to the sometimes inconsistent treatment given transactions under tax and securities laws and the willingness of some to "bend the rules" in one area in pursuit of a result in another.

The United States should continue to explore and implement effective measures to break down the culture of secrecy and obstruction that prevails in many of these off-shore havens. These measures could include legislation or regulations that make doing business in off-shore

jurisdictions less attractive and profitable for U.S. citizens, stricter oversight of the securities side of financial institutions that do business with off-shore entities, and greater regulation, both in terms of substantive requirements and disclosures, of what purport to be "off-shore" securities offerings by U.S. companies and their affiliates. Some of the policy considerations are addressed in my written testimony.

But above all, I believe that I can assure you that aggressive enforcement of the securities as well as the tax laws will be a sound step in continuing to restoring confidence in the fairness of the American securities markets. I can tell you that in the now five years since the collapse of Enron, there is nothing that gets the attention of the business world more than watching investment bankers, executives, lawyers and others who manipulate our system of securities laws convicted and sent to prison.

So let me finish as I began, with the concepts of full disclosure and trust. It is reported that one out of every two adult Americans have invested in the U.S. capital markets that are the crown jewel of our economy. They have done so because they had trust and confidence in a system that provides the information investors need to make wise investment decisions. As we all know from the long history of securities regulation, however, you can't legislate trust. Whatever the detail of the law or regulation, persons will look for ways to circumvent or will simply violate the law. You, however, can ensure that the laws and regulations require complete disclosure and that the penalties for betraying the trust reposed by the investing public are severe and certain.

Thank you again, Mr. Chairman. This Subcommittee has a great tradition. I am quite honored to appear before and to share my thoughts with you.

I would be happy to respond to any questions.

Prepared Testimony[1]

Chairman Coleman, Ranking Member Levin, and Members of the Subcommittee – thank you for the invitation to share my thoughts regarding issues that are of vital importance to our nation's capital markets. As many of you know, I had the privilege of assisting this Committee in 2002 while I served as Special Counsel at the full committee level in the Enron investigation. I now have the good fortune to practice law with one of your former colleagues, Howard Baker. When not actively practicing securities law, which I have done for some 25 years, I also have the privilege of working with the Practising Law Institute where I author one of their securities treatises and speak at certain of their programs on securities law issues. I also am an adjunct professor of law at the Vanderbilt University School of Law where I teach securities law.

The United States federal securities laws are based upon the principle of full disclosure. The disclosure that is required by those laws comes in many forms – information that is required when a company is selling securities; information about the persons seeking to acquire ownership of U.S. public companies and information about the officers, directors and significant shareholders of U.S. public companies. To the extent that the information that is required to be disclosed by U.S. federal securities laws is complete and accurate, the investing public has information with which to make an investment decision. Thus comes the most important by-product of complete and accurate information – trust. Without trust in the underlying information that is disclosed about companies, the markets simply will not function – or will do so in a very imperfect manner.

We have all seen what happens when the investing public loses trust in the financial marketplace. Think – Enron, WorldCom, Tyco, Global Crossing and the list that could go on and on. Indeed, one of the purposes of the Sarbanes-Oxley Act of 2002 was to attempt to restore the public trust in the marketplace – to make financial statements of public companies transparent and reliable. But there is much more to transparency and to what is required to and should be disclosed by companies offering securities in the United States. Some of those items and their importance to the investing public are discussed below. To the extent that overseas companies are used to shield information that is difficult enough to discern even in domestic entities, without question, such use exacerbates the issue of lack of transparency in the U.S. securities markets.

Your current investigation, as did the Committee's investigation in 2002, serves as an alarm that the next imaginative way to attempt to circumvent the spirit, if not the letter, of the United States federal securities laws is only as far away as the length of our memories. Consider the following findings of a United States Senate committee:

- Americans have become suspicious of banking and business practices that, in the public view, have undermined the prosperity of [the past decade].
- Congressional investigations have exposed cases of double-dealing in the securities business. Self-dealing and outright fraud (not the least of which

[1] Portions of this written testimony are excerpted from my book, *Soderquist on the Securities Laws,* Practising Law Institute (5th ed. 2006).

involved a gigantic, rapidly growing energy operation) have become associated with erosion of the stock market.

- Senate hearings have revealed financial irregularities of large New York banks, their executives, affiliated securities companies, and Wall Street investment bankers and securities analysts.
- Leading Wall Street investment banks are under fire for their lending and investing practices. Private side deals and tax avoidance have evoked much criticism of executives and their corporate activities in banking and commerce.

The problem is that these findings that sound as if they are the headlines of 2002 and beyond are actually the findings of a 1932 Senate committee investigating the causes of the 1929 stock market crash. The energy company was not Enron – it was a company run by Sam Insull. The investment banks were not those that had prominent roles in the 2002 collapse of Enron; however, they were their direct corporate predecessors. It does prove the adage that one who forgets history is doomed to repeat it.

What I have done in the following written testimony is provide an overview, first, of the differences under tax and securities laws of a financial instrument known as a prepaid variable forward contract as well as why that instrument came to be developed and how it is used by large shareholder to hedge securities positions. I then provide an overview of various provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and how the spirit, if not the letter, of those laws can be circumvented by affiliates of companies through sales of securities to off-shore entities.

Tax Versus Securities Law Treatment of Prepaid Variable Forwards

Your current investigation also underscores the fact that United States tax laws and United States securities laws often are directly at odds with one another. Nowhere is this difference more pronounced than with the disparate treatment given a certain derivative instrument known as a "prepaid variable forward" contract ("PPVF").

PPVFs were designed as ways to manage (hedge) equity risk after Congress passed the Taxpayer Relief Act of 1997. That legislation amended what constitutes a "constructive sale" – when a transaction is considered a sale for tax purposes even when no asset (in this case, securities) actually is exchanged. Hedges are used when one, perhaps, is "bullish" on a stock and does not want to sell it because of tax considerations but nevertheless wants to diversify his or her portfolio and generate liquidity (cash). Until 1997, the "perfect" hedge for one wishing to limit his or her risk to a large securities position was the "short sale against the box."

After 1997, because of the changes in the constructive sale rules, many traditional hedging strategies became ineffective for tax deferral. In order not to run afoul of the constructive sale rules and trigger taxable gain, taxpayers must retain the potential to make or lose money during the hedge. Accordingly, the PPVF was "born" – and marketed by securities firms under a number of different acronyms – *e.g.*, TRACES, STARS.

In a PPVF, the taxpayer receives an immediate cash payment equal to the present value of a certain dollar value of securities at a future date (referred to as the settlement date), which typically is three to five years after the PPVF is entered into. For example, a taxpayer holding 2 million shares at a current market value of $50 per share might receive $80 million today in exchange for his or her agreement to deliver $100 million worth of the securities at some date in the future. The PPVF contract also typically would provide for a minimum price at settlement (in this example, assume $50), a maximum price (in this example, assume 125% of the current market price, or $62.50), and might provide for 20% of the growth in the stock price beyond that ceiling to be retained by the taxpayer. Typically, the taxpayer can settle the position when the PPVF expires with either cash (in this case $100 million) or deliver the securities with a value of $100 million. The investment bank writing the PPVF would also hedge its position, typically by selling short and, in many cases would borrow from the taxpayer the shares to cover the investment bank's short position.

In the example above, the taxpayer would be fully protected below the current market price; retain all growth in the stock between $50 and $62.50 and 20% of any growth above $62.50. The actual number of shares to be delivered at settlement, however, will not be determined until the settlement date – hence the "variable." That uncertainty as to the number of share to be delivered avoids the constructive sale rules and allows the taxpayer to defer payment of taxes. At settlement, the taxpayer is required, subject to the maximum and minimum, to deliver $100 million of securities. If the market price of the stock has fallen below $50 (the minimum), the taxpayer simply delivers all 2 million shares. If the market price of the stock at settlement is between $50 and 62.50, the taxpayer delivers $100 million in securities; accordingly, if you assume that the market price at settlement is $60, the taxpayer would deliver 1,666,666 shares ($100 million divided by $60) and retain 333,334 shares. If the market price at settlement is at or above the maximum, the taxpayer would deliver 80% of his or her shares since the taxpayer retained 20% of the value above that price. Alternatively, the taxpayer could settle the position in cash, making the PPVF appear as a combination of a put, a call and a loan all rolled into one instrument.

Congress indicated when it passed the constructive sale rules that one could hedge a position with options (puts and calls) and thus create a collar so long as the hedged position is not "abusive." Congress did not define "abusive" and the Internal Revenue Service has yet to issue regulations in this area. In a Committee report, however, Congress gave as an example of a put equal to 95% of the current market price and a call that was sold giving away all appreciation above 110% of the current market price. Believing that Congress would not deem its own example as "abusive," most practitioners have used the 15% band in Congress' example as the minimum band of upside/downside.

Although one also can structure a "no-cost collar" using a combination of a put and a call, some also desire to obtain liquidity (cash) to reinvest in other securities. The problem with a collar is that if one seeks to borrow against that position, Federal Reserve margin rules limit borrowing to not more than 50% of value of the position. In the case of a PPVF, however, one can generate 80 to 90% of the value of the market price as a cash advance. It generates more money than an outright sale (because of the tax deferral) and does not lock the person into a sale because at settlement, one can settle in cash and keep the shares. The entire proceeds of the

PPVF also can be reinvested in other equities in order to diversify – they are not subject to the Federal Reserve's margin requirements.

For securities law purposes, however, the entry into the PPVF is treated as a sale of the maximum number of shares that might be required to be delivered by the taxpayer. Accordingly, in the example above, the taxpayer, if (as is further explained below) an affiliate or an officer, director or greater than 10% shareholder of the issuer of the shares, would be required to make certain regulatory filings required by the SEC (*e.g.*, Form 144, Form 4, Schedule 13D/G) at the time the PPVF is entered into. A December 20, 1999 no-action letter issued by the SEC to Goldman Sachs effectively layed out the template for the SEC's analysis for these filings. Significantly, however, for regulatory purposes, the date of sale is the date the PPVF is entered into; while for tax purposes, it is the settlement date, thus deferring taxes associated with selling.

As mentioned above, the counterparty to the PPVF (the investment bank writing the PPVF contract) often takes as collateral the stock of the taxpayer that is being hedged. A recent IRS Technical Advice Memorandum ("TAM") indicates that execution of a PPVF coupled with simultaneous lending of the shares to the same counterparty will be treated as a taxable sale of the underlying securities. This particular ruling would bring tax law and securities law somewhat closer (at least in regard to the exact facts in question – PPVF coupled with simultaneous lending to same counterparty) because the 1999 no-action letter referred to above, if followed, also would allow the counterparty to have the securities "cleansed" – *i.e.*, restrictive legends removed and allow the securities to become freely tradable. The practical import of this is discussed further below in connection with the discussion of resales of "control" and "restricted" securities.

Policy Questions and Issues to Consider:

- Should the proceeds received from entering into PPVFs be treated as "loans" and subjected to the same margin requirements as traditional loans?

- Should the SEC change its position that PPVFs are treated as sales when the PPVF is entered into, thus allowing the securities that are the subject of the PPVF thereafter to be freely tradable?

- Given the IRS 2006 TAM, will the reference to "same" counterparty give rise to the use of off-shore entities that in fact are controlled by the counterparty in order to attempt to continue to use PPVFs to defer taxes but avoid the restrictions of the TAM?

United States Federal Securities Law Issues

The following highlights the securities law concepts and issues that most likely have arisen or will arise in the course of your investigation.

Issues Arising Under The Securities Act of 1933

Purpose of the Securities Act of 1933

The purpose of the Securities Act of 1933 (the "Securities Act") is to prevent the unregistered distribution of securities to the United States investing public by companies (issuers) and their affiliates. The purpose of registration is disclosure – investors acquiring securities in a public offering (a distribution) are afforded the protection of the Securities Act. That protection is the information that is required to be contained in a registration statement and prospectus and that sellers and underwriters of securities in distributions be subject to certain liabilities set forth in the Securities Act, most notably, sections 11 and 12.

From the framework of the Securities Act, we arrive at three types of offers and sales of securities – registered, exempt and illegal. The Securities Act is a transaction statute – every securities transaction must be registered unless there is an exemption in the statute for the transaction or the security itself is exempt.

The Securities Act registration exemption that allows most security holders to sell securities without registration is section 4(1), which covers "transactions by any person other than an issuer, underwriter, or dealer." It is easiest to determine the availability of that exemption by first answering a preliminary question: are the securities proposed to be sold control securities or restricted securities?

Control Securities

"Control" securities are securities owned by a person or entity that is an affiliate of the issuer. To understand the concept of control securities, it is helpful to look to Securities Act Rule 405, a definitional rule that defines "affiliate" and "control" as follows:

> *Affiliate.* An "affiliate" of, or person "affiliated" with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified.
>
> *Control.* The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

To fully understand the concept of "control," however, one also must understand what the "power to direct or cause the direction of . . . management and policies" means. First, even unexercised ability to control is control. For example, if a shareholder owns sufficient stock in a corporation such that management is likely to be responsive to the shareholder's requests or demands, the SEC would deem that shareholder to be an affiliate of the corporation. It is irrelevant that the shareholder pays no attention to the management of the corporation.

That then necessarily leads to the question of how much stock is enough to control a corporation. There is no fixed answer, but 10% equity ownership is a rule of thumb. Obviously, many shareholders who own that percentage of stock, or even a much greater percentage, are not

in control of a corporation. For example, a shareholder who owns a large minority interest may be excluded from power by a management that holds a majority interest. When a shareholder has a 10% interest, however, the SEC will probably consider the shareholder to be an affiliate, unless someone convinces the SEC otherwise.

Second, one must be familiar with the concept of a control group. Under this concept, a person is in control if he or she is a member of a group that controls. That theory applies to shareholders who may be considered part of a control group. A family is a classic example. Another would be one or more persons acting in concert with respect to the ownership or voting of the securities in question. The theory also is used to bring corporate officers and directors under the concept of "control."

Restricted Securities

"Restricted securities" is a simpler concept than "control securities." Rule 144(a)(3) defines "restricted securities" as:

(i) Securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering;

(ii) Securities acquired from the issuer that are subject to the resale limitations of Regulation D or Rule 701(c);

(iii) Securities acquired in a transaction or chain of transactions meeting the requirements of Rule 144A;

(iv) Securities acquired from the issuer in a transaction subject to the conditions of Regulation CE;

(v) Equity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions of Rule 901 or Rule 903 under Regulation S;

(vi) Securities acquired in a transaction made under Rule 801 to the same extent and proportion that the securities held by the security holder of the class with respect to which the rights offering was made were as of the record date for the rights offering "restricted securities" within the mean of this paragraph (a)(3); and

(vii) Securities acquired in a transaction made under Rule 802 to the same extent and proportion that the securities that were tendered or exchanged in the exchange offer or business combination were "restricted securities" within the meaning of this paragraph (a)(3).

For the Subcommittee's purposes, I believe you need only be concerned with subsections (i) and (v). Subsection (i) relates to "Securities that are acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering." That part of the definition covers securities that: (1) at one point were sold

by the issuer under a section 4(2) nonpublic offering exemption (either in a statutory private placement or in a sale under Securities Act Rule 506) or a section 4(6) limited offering exemption; or (2) at one point were sold by an affiliate of the issuer in a private resale using the section 4(1) exemption. The current holder may have purchased the restricted securities directly from the issuer or an affiliate of the issuer, or there may have been a chain of transactions that separate the current holder from one of those sellers. When there is such a chain of transactions, each intervening sale must be a private resale that uses the section 4(1) exemption. Thus, the straightforward thrust of this part of the definition is that purchasers in transactions under section 4(2) or 4(6) buy restricted securities.

The fifth part of the definitions covers "Equity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions of Rule 901 or Rule 903 under Regulation S." Regulation S is discussed below.

Regulation S Sales – Off-shore Sales and Resales

Regulation S is a series of rules (Securities Act Rules 901 through 905) adopted to provide an exemption from registration under the Securities Act for offerings and sales of securities occurring outside the U.S. The exemption was intended to help U.S. and foreign companies raise capital overseas quickly and inexpensively without having to comply with the registration process mandated under section 5 of the Securities Act. Regulation S provides two "safe harbors" from the Securities Act's registration requirements. One – the issuer safe harbor – is applicable to offers and sales by issuers, distributors and their respective affiliates. The second – the resale safe harbor – is applicable to resales by other parties. An offer, sale or resale of securities meeting all of the requirements of the applicable safe harbor is deemed to occur outside the U.S., and accordingly is not subject to the Securities Act's registration requirements.

In addition to other requirements, the availability of either safe harbor is subject to the satisfaction of two basic conditions (in addition to other requirements): first, the offer or sale of securities must take place in an *"offshore transaction,"* meaning that (1) the offer is not made to a person in the U.S. and (2) the buyer is (or is reasonably believed by the seller to be) outside the U.S. at the time of the sale, or the sale is made through an established foreign securities exchange, or through the facilities of a designated foreign securities market, and the transaction is not pre-arranged with a U.S. buyer. Second, *no "directed selling efforts"* may be made within the U.S. in connection with the transaction. "Directed selling efforts" means any activity, with certain limited exceptions, undertaken for the purpose of, or that could be reasonably expected to result in, conditioning the U.S. market for the relevant securities

The issuer safe harbor is available to issuers, distributors, their respective affiliates and any person acting on behalf of any of these parties. The issuer safe harbor provisions classify securities into three categories for purposes of determining whether additional conditions must be met in order to qualify an offering as exempt from registration under the issuer safe harbor. The categories distinguish securities based upon (i) the issuer's jurisdiction of organization, (ii) the issuer's reporting status under the Securities Exchange Act of 1934, and (iii) the degree of "U.S. market interest" in the class of securities being offered or sold.

The resale safe harbor applies to resales by persons other than parties eligible to utilize the issuer safe harbor. Generally, to claim the resale harbor, these parties are required to comply with the "offshore transaction" and "no directed selling efforts" requirements discussed above. In addition, dealers are prohibited from knowingly selling Regulation S securities to U.S. purchasers during the applicable "distribution compliance period" (generally one year); when a purchaser is also a dealer, the selling dealer must notify the purchaser that the purchaser is subject to the same resale restrictions as the seller; and the selling concession or other fee payable when the offer or sale is made by certain affiliates is limited to a customary broker's commission.

With respect to stock issued by domestic public companies, during the first year following purchase, the securities are subject to Regulation S's distribution restrictions, and during the second year (and thereafter for purchasers affiliated with the issuer), the securities are subject to the volume and other resale restrictions under Rule 144. In addition, in connection with equity offerings by domestic public companies: each purchaser must certify that it will resell the shares (and engage in hedging transactions) only in compliance with the registration provisions of the Securities Act or exemptions therefrom, or in accordance with Regulation S; the issuer is required to legend the offered shares to give notice to subsequent buyers of the applicable resale restrictions; and the issuer is required to refuse to register any transfer of the shares unless it is made in accordance with the Securities Act's registration provisions, an exemption therefrom or Regulation S. These provisions are designed to prevent "flowback" of securities into the United States before they have "come to rest" outside the United States – *i.e.,* to prevent purportedly off-shore transactions from being used as devices to circumvent the Securities Act's limitation upon unregistered distributions in the United States.

Resales of Control Securities

As indicated above, Securities Act section 4(1) provides the exemption that allows most security holders to sell securities without registration. That exemption is available to any person that is not an "issuer, underwriter or dealer." Those terms are defined in section 2 of the Securities Act. For purposes of the Subcommittee, I believe that what is important to your investigation is who can be an "underwriter."

Securities Act section 2(a)(11) defines "underwriter" 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." As it relates to an affiliate who holds securities that are control securities and not also restricted securities, there would be little problem if the definition stopped there. It does not, however. The last sentence of section 2(a)(11) adds: "As used in this [section 2(a)(11) – the definition of "underwriter"] the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." In other words, the basic definition of "underwriter" should be treated as if it read: "The term 'underwriter' means any person who has purchased from an issuer or affiliates of the issuer with a view to, or offers or sells for an issuer or an affiliate of the issuer in connection with, the distribution of any security."

"Distribution" is not defined in the statute, but it is understood essentially to be synonymous with "public offering." For example, in an early case the SEC established that a distribution comprises "the entire process by which in the course of a public offering a block of securities is dispersed and ultimately comes to rest in the hands of the investing public." The concept of "coming to rest" involves the requirement of a holding period before restricted or control securities may be resold – evidence of one's investment intent – *i.e.,* if you have purchased for investment rather *than with a view toward distribution*, you are not an "underwriter."

Because of the way in which the term "underwriter" is defined, a securities firm that handles the sale of control securities in the public markets may be considered an underwriter. If it handles the sale as a dealer (as the term is used in the securities industry, that is, if it buys the securities itself with the idea of reselling them), it may be considered to have "purchased from an issuer [or an affiliate of the issuer] with a view to . . . distribution." If it handles the transaction as a broker (that is, if it merely sells the securities for the affiliate), it may be considered to have offered or sold "for an issuer [or an affiliate of the issuer] in connection with . . . the distribution." In either case, the series of transactions by which the securities pass from the affiliate to the public is considered to constitute one distribution that is partially "by" an underwriter. When that is the case, the section 4(1) exemption is not available, and the registration requirement of section 5 of the Securities Act is violated.

The problem for a securities firm purchasing from or selling on behalf of an affiliate of the issuer and becoming a statutory "underwriter" is significant – there is no exemption in the Securities Act available to underwriters in any circumstance. It may appear that securities would always have to be registered before an affiliate could sell them publicly, because it may seem that such a sale always would constitute a distribution. Considering the costs involved in preparing and filing a registration statement, that would mean that it would not be economically feasible for an affiliate to sell control securities except in a transaction involving at least some hundreds of thousands of dollars. That result is not what was contemplated by the drafters of the Securities Act, and the SEC has never taken that extreme position. Rather, as discussed below, the SEC has built some flexibility into the Securities Act through the concept of what constitutes a "distribution."

As mentioned above, the SEC early on determined that a distribution comprises "the entire process by which in the course of a public offering a block of securities is dispersed and ultimately comes to rest in the hands of the investing public." Notwithstanding the expansive nature of that concept, prior to the mid 1940s the SEC allowed affiliates publicly to sell unregistered control securities in limited circumstances. Various administrative actions of the SEC held no distribution to be involved when an affiliate sold control securities, on a stock exchange, in a transaction in which the selling broker limited its activities to the usual brokerage functions—and, most important, when the broker did not solicit any orders for the securities. Under that interpretation of "distribution," affiliates had a ready market for their securities, as long as the amount of securities involved in a particular sale was small enough to be salable, at a reasonable price, without one or more securities firms' soliciting buyers.

The SEC reversed course in 1946 in *In re Ira Haupt & Co.* In that case, affiliates sold during a five-and-one-half-month period of 1943, publicly, and through a broker, stock representing approximately 38% of their company's common stock. By its finding that the *Haupt* facts constituted a distribution, the SEC made it clear that, although it was willing to allow control securities to trickle into the market, it would not allow a flood. That decision made the securities firm that handled the sales an underwriter, which caused the section 4(1) exemption to be unavailable. The problem with *Haupt* was that its facts were too far from the ordinary sale of securities by an affiliate for the case to provide much guidance. Securities firms knew they would be underwriters if they replicated the facts of *Haupt,* but they did not know where the SEC would draw its line separating allowable transactions from distributions. Particularly troubling was the fact that the SEC, while failing to give guidelines, overruled the prior staff interpretations that had allowed at least small scale market sales by affiliates through brokers.

In 1954, when it adopted Rule 154, the SEC took definitive action on the questions left open in *Haupt.* That rule, which was later superseded by Rule 144, used the old SEC staff interpretations as a starting point and added a numbers test to determine the existence of a distribution. Under the rule, no distribution occurred when:

(1) all sales were by a broker, who performed only ordinary brokers' functions and who received only the usual commission;

(2) neither the broker, nor to the broker's knowledge the seller, solicited any orders;

(3) the broker was not aware of circumstances indicating that the sales were part of a distribution; and

(4) the amount of securities sold in six months did not exceed approximately one percent of the total outstanding securities of the same class.

That rule alleviated a good bit of the problem generated by *Haupt* and, as discussed below, its concepts were carried over into Rule 144 when it was promulgated in 1972.

<u>Resales of Restricted Securities</u>

Outside of Rule 144, there never has been a corollary to Rule 154 relating to the sale of restricted securities. Although Rule 144 is not the exclusive mechanism for resales of restricted securities purchased after its effective date, most practitioners would agree that selling restricted securities outside the rule rarely would be wise. This is particularly true with Rule 144's requirements having been gradually relaxed over the years. The most significant example of this relaxation is the reduction of the holding period for restricted securities from three years in the original rule to one year in the current version of the rule.

The holding period is perhaps the most important element of Rule 144 because it is thought that the length of the holding period is objective evidence of the holder's investment intent, or the lack thereof, at the time of original purchase. A purchaser's investment intent is

important because the opposite of investment intent is "view to distribution." And, under section 2(a)(11), purchasing with a view to distribution makes the holder an "underwriter."

Alternatively, a person who sells restricted securities too soon after their purchase may be considered an underwriter under the theory that the sale is "for an issuer in connection with [a] distribution." The reasoning behind that conclusion starts with the idea that a distribution is not complete until the securities have come to rest in the hands of persons who are not "merely conduits for a wider distribution." The argument may then proceed that:

(1) the issuer knows or should know that some purchasers of restricted securities will want to resell fairly quickly after their purchase;

(2) a purchaser is able to resell quickly only because the issuer does not take effective steps to prevent it (such as contractual provisions prohibiting the resale and legends on the certificates representing the securities); and

(3) since the issuer is responsible for the resale, the resale will be measured as simply a part of a larger distribution of the securities by the issuer to the public through an underwriter.

Notice that from the point of view of the purchaser who last resold, the alternative theory is the more dangerous theory. Under the first theory, a purchaser may have a good chance of convincing a court that he or she did not purchase securities with a view to distribution, notwithstanding the shortness of the holding period. Under the second theory, however, the intent of the purchaser is irrelevant, as is the intent of the issuer.

Prior to passage of rule 144, the question was how long a holding period was required to avoid these problems. It is clear that no holding period removes the taint of underwriter status from someone who has purchased with a distribution in mind. In the usual situation, however, a sufficiently long holding period dispels any notion that a reseller of restricted securities is an underwriter, and two years came to be viewed by securities lawyers as the minimum safe holding period of restricted securities before a public sale. Before the passage of Rule 144, the SEC staff responded to a multitude of no-action letter requests in connection with potential resales of restricted securities. The staff freely granted no-action letters when restricted securities were held for three years, but was much less likely to do so in the case of a two-year holding period.

Public Resales Under Rule 144

As indicated by the title of Rule 144, "Persons Deemed Not to Be Engaged in a Distribution and Therefore Not Underwriters," the rule is designed to provide a mechanism for avoiding underwriter status. The rule applies in two instances:

- to any affiliate or other person selling restricted securities of an issuer for his own account, or

- to any person who sells restricted or any other securities for the account of an affiliate of the issuer of such securities.

Assuming the rule's other requirements (*e.g.*, current public information, volume limitations, manner of sale and filing) are met, sales by these persons shall be deemed not to be a distribution of such securities and therefore the person selling shall not be an "underwriter."

Referring back to the discussion of "control" and "restricted" securities set forth above, and the theories by which sellers and brokers may be tainted with underwriter status, makes Rule 144 decipherable. The first instance covers restricted securities by any person and the second clause relates to control securities. Notice that the focus in the first instance is on the holder of securities, while in the second it is on the person who sells securities for the holder. That, of course, is consistent with the earlier discussion of how the taint of underwriter status arises differently in the case of restricted and control securities.

Securities Act Liabilities

Since many, if not all, of the transactions under investigation involve purportedly exempt transactions as opposed to registered offerings, I would be remiss if I failed to mention an anomaly resulting from the U.S. Supreme Court's decision in *Gustafson v. Alloyd Co., Inc.* The principal liabilities for violations of the Securities Act are set forth in section 11 and section 12. Section 11 involves liability for false or misleading registration statements and, therefore, is not applicable to exempt (non-registered) offerings of securities.

Section 12(a)(2), however, provides a cause of action for a false or misleading "prospectus." The *Gustafson* Court interpreted "prospectus" as meaning a prospectus in a registered offering despite the expansive definition of "prospectus" in the Securities Act that includes many types of securities offering documents. Lower courts quickly followed the *Gustafson* decision and ruled that section 12(a)(2) gave no private cause of action to one who purchased securities in a private (non-registered) transaction; *i.e.*, a "private placement." As a result, there is no effective Securities Act remedy for a purchaser of securities in a non-registered offering. That simply could not have been the Congressional intent and deserves study on Congress' part to consider overruling the *Gustafson* decision.

Policy Questions and issues to Consider

- Should Regulation S dealing with off-shore transactions be further amended to require additional disclosure or due diligence with respect to the off-shore entities to which securities are sold and additional restrictions with respect to "flowback" into the United States markets?

- Should Congress address the lack of an effective Securities Act remedy for fraud in connection with private transactions that resulted from the Supreme Court's *Gustafson* decision?

Issues Arising Under The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 (the "Exchange Act") is more expansive in its coverage that the Securities Act. The Exchange Act, among other things, regulates trading markets and also prescribes information that is required to be filed by companies after they become public. It also requires disclosures by persons acquiring significant holdings in United States public companies as well as by the officers and directors of those companies.

Williams Act

Certain provisions relating to beneficial ownership reporting and tender offer regulation, also known as the Williams Act, were passed in response to certain tender offer and related practices that Congress in the 1960s deemed abusive. The Williams Act added to the Exchange Act sections 13(d) 13(e), 14(d), 14(e), and 14(f). Section 14 is of little interest to the issues being studied by the Subcommittee as they relate almost exclusively to regulation of tender offers.

Section 13(d) is aimed at tender offers only indirectly. It requires a person who owns beneficially more than 5% of a class of equity security registered under the Exchange Act, within ten days after the acquisition of securities that triggers the reporting requirement, to provide certain information to the issuer, to the SEC, and to each exchange on which the security is traded. The section contains a list of such information, but it also gives the SEC the power to add to or subtract from the list. Exchange Act Regulation 13D-G is the SEC's response, and it details the disclosure requirements. The resulting disclosure document, Schedule 13D, is designed basically to give management of the issuer information concerning potential tender offerors. That information includes the number of shares beneficially owned by the reporting person, the source of funds used to purchase the shares, and, if the purpose of the purchase of shares is to acquire control of the issuer, any plans of the reporting person to liquidate the issuer, to sell its assets, to engage it in a merger, or to effect any other major change in its structure. Under section 13(d), amendments to that schedule must be filed upon the occurrence of material changes in the disclosed information.

The other Williams Act provision, section 13(e), gives the SEC the power to regulate repurchases by issuers of their own equity securities. The SEC has done this by extensive rulemaking in the areas of "issuer tender offers" and "going private" transactions, including the requirement to file, in specified circumstances, Schedule 13E-3 and schedule TO, which require substantially more disclosure than schedule 13D.

The key to the Section 13 reporting obligations is the determination of "beneficial ownership." Much like the "affiliate" concept under the Securities Act, the Exchange Act recognizes "control groups," each member of which is deemed the beneficial owner of the group's securities. I also draw the Subcommittee's attention in particular to SEC Rule 13d-3, which, in part, provides as follows:

§240.13d-3 **Determination of beneficial owner.**

(a) For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:

   (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or,

   (2) Investment power which includes the power to dispose, or to direct the disposition of, such security.

(b) Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose or effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security.

Securities Exchange Act – Section 16

Exchange Act section 16 was an original section of the Exchange Act that, like many we have seen, was directed at unscrupulous practices discovered by the U.S. Senate while investigating the causes of the 1929 stock market crash:

> Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.

Accordingly, Congress added section 16 to the Exchange Act as a means to minimize the unfair use of inside information. Here, it is worth noting that the use of inside information also is regulated by Exchange Act section 10(b) and Rule l0b-5. The two provisions, however, are entirely different in their coverage and operation. Rule l0b-5 is a fairly refined weapon aimed at discrete acts of wrongdoing. Section 16, on the other hand, is a loaded gun that can hit the innocent as easily as the guilty. Section 16(b) operates without consideration as to whether an insider actually was aware of material nonpublic information. Under that section, "profit" made by insiders from transactions involving equity securities of publicly held companies, when a "purchase" and a "sale" (in any order) are made less than six months apart, must be disgorged and paid over to the issuer.

In addition to the liability provision mentioned above, section 16 also has a *reporting* provision. Accordingly, before examining section 16(b), it is helpful to discuss section 16(a).

That section requires, in addition to directors and executive officers, beneficial owners of more than 10% of any class of equity security that is registered under the Exchange Act to file reports with the SEC and relevant securities exchanges concerning their holdings of all equity securities of such issuers.

In determining who is a *beneficial owner* for purposes of section 16, the SEC's regulations provide, in relevant part, that:

> Solely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered pursuant to section 12 of the Act, the term "beneficial owner" shall mean any person who is deemed a beneficial owner pursuant to section 13(d) of the Act and the rules thereunder; *provided, however,* that [certain] institutions or persons shall not be deemed the beneficial owner of securities of such class held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business (or in the case of [certain] employee benefit plan[s], of securities of such class allocated to plan participants where participants have voting power) as long as such shares are acquired by such institutions or persons without the purpose or effect of changing or influencing control of the issuer or engaging in any arrangement subject to Rule 13d–3(b) (§240.13d–3(b)):

The cross reference to section 13(d) and Rule 13d-3(b) brings the "use of trusts to circumvent reporting" concept into section 16 and subjects persons engaging in such conduct to the reporting and possible draconian sanctions of Section 16.

Closing

I hope that the foregoing overview of these important and sometimes difficult securities law concepts is helpful to the Subcommittee in its investigation and in understanding how the use of off-shore entities, by company affiliates or otherwise, can be used in ways that circumvent the spirit, if not the letter of the United States securities laws.

With that, let me finish as I began, with the concepts of full disclosure and trust. It is reported that one out of every two adult Americans have invested in the U.S. capital markets that are the crown jewel of our economy. They have done so because they had trust and confidence in a system that provides the information investors need to make wise investment decisions. As we all know from the long history of securities regulation, however, you can't legislate trust. Whatever the detail of the law or regulation, persons will look for ways to circumvent or will simply violate the law. You, however, can ensure that the laws and regulations require complete disclosure and that the penalties for betraying the trust reposed by the investing public are severe and certain.

Thank you again, Mr. Chairman. This Subcommittee has a great tradition. I am quite honored to appear before and to share my thoughts with you.

I would be happy to respond to any questions.