

# Herbert Smith

September 4, 2007  
Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

Re: Securities and Exchange Commission Release No. 33-8813, File No. S7-11-07 – Revisions to Rule 144 and Rule 145 to Shorten Holding Period for Affiliates and Non-Affiliates (the "New Release")

Dear Ms. Morris:

The New Release solicits comments about Regulation S, asking whether amendments should "conform the one-year distribution compliance period in Rule 903(b)(3)(iii) to the proposed six-month holding period" in Rule 144.<sup>1</sup> We would very much support shortening the distribution compliance period to six months if Rule 905 is eliminated as well. However, if Rule 905 of Regulation S remains in place and the proposed tolling provisions are adopted, then shortening the distribution compliance period to six months arguably yields only marginal benefits for Regulation S offerings by US issuers<sup>2</sup>.

Moreover, if the distribution compliance period is left at one year and the amendments to Rule 144 set forth in the New Release are adopted, then Rule 905 becomes unnecessary for the reasons explained below. By eliminating Rule 905, the SEC would eliminate significant market uncertainty over the rule's applicability. An aim of the New Release is to "increase the liquidity of privately sold securities and...enable companies to raise capital more often

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<sup>1</sup> Securities of US issuers traded offshore under Regulation S face two types of limitations, each from a different source: the distribution compliance period from Regulation S and the holding period from Rule 144. The distribution compliance period prohibits resales to any U.S. person, whereas the holding period prohibits public resales in the United States but permits private placements with qualified U.S. buyers. The distribution compliance period is internal to Regulation S, contained in Rule 902 through Rule 904. The holding period originates in Rule 144, which defines certain securities as "restricted securities." Rule 905 of Regulation S links the two periods, deeming U.S. domestic equity securities acquired offshore or resold in reliance on Regulation S to be "restricted securities" under Rule 144.

<sup>2</sup> Because securities trading offshore are generally held through intermediaries, holders of such securities are unlikely to know who held the security in the past and even if they did know who held the security they are unlikely to know if that person engaged in hedging activities. Thus the requirement set out in footnote 69 of the New Release—that if the security holder "is unable to determine that the previous owner did not engage in hedging activities...then the security holder should omit the period in which the security holder is not able to [make such determination] when calculating the holding period"—means that holders of previously traded securities will be unable to tack the holding period of the previous holders. Consequently, the securities will still be subject to the holding period of a full year, pursuant to Rule 905. This will, for the reasons explained below, eliminate any real benefit to having a distribution compliance period of only six months. For securities of non-reporting US issuers, too, the holding period would remain at one year, so shortening the distribution compliance period to six months would for the same reasons provide little if any benefit.



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through the issuance of securities in unregistered transactions, such as offshore offerings under Regulation S." Leaving Rule 905 in place after adopting the provisions of the New Release would perpetuate uncertainty that could only frustrate the SEC's policy goals without providing any real benefit.

## I. Current market uncertainty

Currently, Regulation S offerings of US domestic issuers are subject to both the one-year distribution compliance period and, via Rule 905, the restrictions of Rule 144. The restrictions of Rule 144 are in certain circumstances arguably more restrictive than the restrictions of the distribution compliance period. As a result, there is uncertainty in the market as to precisely what restrictions, if any, Rule 905 adds to the distribution compliance period.

Although the uncertainty exists for many reasons, a statement on pages 27-28 of the New Release is worth noting: "When Regulation S was amended in 1998, the distribution compliance period applicable to U.S. companies (Category 3 issuers) was conformed to the one-year holding period under Rule 144." Many practitioners have taken comments like this one to mean that compliance with the distribution compliance period automatically implies compliance with Rule 905. On this view, Rule 905 adds no additional substantive restrictions to those already present in the distribution compliance period. Other practitioners have noted that, though resales of restricted securities are currently permitted after one year, such securities afterward remain subject to Rule 144's volume and manner of sale limitations. But sellers of securities in offshore transactions pursuant to Regulation S generally do not track which sales comply with Rule 144 requirements, because Rule 144 is irrelevant for typical Regulation S transactions occurring purely offshore. Accordingly, they have no way of knowing which securities are unrestricted and which remain restricted.

Some practitioners have maintained that if the securities remain restricted after the lapse of the distribution compliance period, safeguards must prevent unrestricted resales in the United States until, for non-affiliates, the two-year restricted period pursuant to Rule 144(k) has ended. Even among such practitioners, there is no general agreement as to what safeguards would be adequate. For example, may the securities be traded in book-entry form, through an international clearance and settlement system like CREST, or must the securities be traded in certificated form? Such uncertainty has hampered the development of capital formation in the market.

Shortening the distribution compliance period to six months without the elimination of the Rule 905 would mean that the current uncertainty regarding the application of Rule 905 would continue. Because securities of non-reporting U.S. companies would (and reporting U.S. companies may) face a holding period lasting one year, the holding period could outlast the distribution compliance period. Some practitioners would continue to believe that Rule 905 adds no substantive restrictions. Others would argue that since offers of securities can be made into the U.S. even if they are traded and settled offshore means that even after the lapse of distribution compliance period Rule 905 may still impose volume and manner of sale limitations as well as a longer holding period. Even securities of reporting companies would be affected, because the proposed tolling requirements could extend the holding period beyond a six-month distribution compliance period.



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## II. Summary of recommendation

Clearly the preferred option would be to shorten the distribution compliance period to six months and eliminate Rule 905. However, if the SEC is not prepared to do this the New Release provides an easy opportunity to eliminate the market uncertainty described above. If the amendments to Rule 144 are adopted as the New Release proposes while the distribution compliance period is left unchanged at one year then Rule 905 becomes unnecessary. Eliminating Rule 905 would come at almost no cost and yield significant benefit.

The proposed changes would alter Rule 144 so that its inclusion within Regulation S would serve almost no function; the other provisions of Regulation S (Rule 901 through Rule 904) would nearly subsume Rule 905. This is because the requirements imposed by the distribution compliance period would be generally more stringent than the requirements imposed by Rule 144. Under the proposed changes, the holding period (even when tolled) cannot outlast the distribution compliance period, assuming the distribution compliance period remains one year long. Because Rule 905 imposes no substantive restrictions before the lapse of distribution compliance period, Rule 905 would itself become superfluous.

If Rule 905 retains purpose or function, we would appreciate clarification. Otherwise, except in a few narrow and trivial cases that we were able to identify and that are outlined before, Rule 905 would no longer be relevant. We believe the SEC will want to eliminate the rule. At minimum, Rule 905 should be amended to clarify its narrow scope of applicability.

## III. The general pattern

During the distribution compliance period, securities may not be sold to any U.S. persons, whether ordinary investors or large institutional buyers. Moreover, a seller under Regulation S may not engage in directed selling efforts in the United States and any offer and the sale must be made in an offshore transaction. The SEC imposes these standards so as to ensure that the persons relying on Regulation S are not "engaged in an unregistered, non-exempt distribution into the United States capital markets," as the New Release states. Under Rule 144 a different purpose: to define the types of domestic resales that may occur without the seller qualifying as an underwriter. As such, the restrictions imposed by Rule 144 are less stringent than those imposed by the distribution compliance period. Rule 144 exists precisely because it contemplates resales to certain U.S. persons while such resales are expressly prohibited during the distribution compliance period. Rule 144 permits, for example, resales to "qualified institutional buyers" under Rule 144A.

Because the distribution compliance period is more stringent than Rule 144, the holding period under the Rule will have a purpose only if it outlasts the distribution compliance period. But under the changes proposed by the New Release plus an unchanged distribution compliance period, the holding period under Rule 144 generally cannot outlast the distribution compliance period.

Under the New Release's provisions, non-affiliates after one year will enjoy unlimited public resale under Rule 144 without having to comply with other Rule 144 requirements.



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These securities will be "washed" of all restriction. Affiliates, after their holding period, may resell only in accordance with all other Rule 144 requirements including current public information, volume limitations, manner of sale for equity securities, and filing of form 144. However, any sales by an affiliate of a U.S. domestic issuer pursuant to Regulation S would trigger a new distribution compliance period. Once again Rule 905 would serve no purpose.

## IV. Exceptions

We have found two exceptions to the general pattern described above. In these two circumstances, the holding period would stand alone so that Rule 905 would matter.

First, suppose a non-affiliate who had been an affiliate within the previous three months sells a domestic equity security after the lapse of the distribution compliance period. Rule 905 would require the purchaser to follow Rule 144 restrictions on subsequent resales into the United States. This is because Rule 905 deems domestic equity securities acquired from affiliates to be restricted securities pursuant to Rule 144, and Rule 144 treats disaffiliated sellers as affiliates until the passage of three months since the time of disaffiliation. The holding period and other Rule 144 restrictions on affiliates would remain in force; having begun when the now-disaffiliated seller first acquired the security, they would not expire until three months after the affiliate became a non-affiliate (unless they ran their course prior to that date). Were Rule 905 eliminated, the purchaser could resell the security without facing restrictions from Rule 144. The security could immediately flow into the United States.

Second, Rule 905 would retain relevance for domestic equity securities traded under Regulation S that are offered and sold to employees of the issuer or affiliates as part of an employee benefit plan governed by non-U.S. law, provided that four additional conditions mandated by Rule 903(b)(1)(iv) are met. Rule 903 classifies such securities under Category 1, where there is no distribution compliance period, rather than under Category 3, where other domestically issued securities face the distribution compliance period of one year. Rule 905 would matter by imposing the holding period.

## V. Analysis

In practice, Rule 905 would matter only in the two cases described above, each extremely narrow in scope. Even in those cases, Rule 905 would not do much. In the first exception, although elimination of Rule 905 would allow the purchaser to resell the security to U.S. persons without waiting out the additional holding period, the SEC may be assured that the security would have already undergone a strict distribution compliance period during which no U.S. person, not even a qualified institutional buyer, could touch it. If Rule 905 were kept and a holding period applied, the holding period would apply for a mere three months at maximum (the security would lose all Rule 144 restrictions three months after the affiliate became a non-affiliate.) Resellers would have to satisfy so many arcane conditions for Rule 905 to matter that even well-intentioned, sophisticated investors might overlook the rule's relevance. In the second example, the rest of Regulation S imposes safeguards that make the Rule 905 holding period partially redundant. Were Rule 905 eliminated, the issuer still must not engage in directed selling efforts in the United States and must take reasonable steps to preclude the offer and sale of the securities or of interests



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in the pension plan to U.S. residents other than employees on temporary assignment in the United States, pursuant to Rule 903(a)(2) and Rule 903(b)(1)(iv)(C), respectively. If kept, Rule 905 would more likely breed market confusion than prevent unfair distribution.

Rule 905's elimination is sensible in theory as well. If the New Release's provisions are adopted, Rule 905 will no longer serve the purpose for which it was designed. The SEC adopted Rule 905 in 1998 in order to curb abusive practices that had emerged since the adoption of Regulation S in 1990. The adopting release, number 33-7505, rightly faulted some non-affiliates for acting as though the distribution compliance period washed their domestic equity securities of all restriction—when those securities if they had been sold within the United States would have been "restricted" under Rule 144 and subject to a one-year (and until 1997 amendments, three-year) holding period as well as volume and manner of sale limitations for another year. The SEC adopted Rule 905 to end such abuse. Rule 905 had at least the following rationale: because the holding period under Rule 144 could outlast the distribution compliance period, additional protections were in place to prevent the distribution of "restricted" securities in the U.S. (leaving aside the question of whether in practice Rule 905 has fulfilled that function). But if the distribution compliance period circumscribed the holding period under Rule 144, Rule 905 would lose its purpose. Nothing inherent to the theory of offshore placement under Regulation S requires securities to be restricted under Rule 144.

## VI. Conclusion

If the distribution compliance period remains at one year we hope the SEC will eliminate Rule 905 along with its corollary, Rule 144(a)(3)(v). Once the New Release's provisions are adopted, Rule 905 would appear much broader than it will in fact be. Its narrowness of scope, and triviality in the few cases to which it applies, makes us question whether even its shell should remain. We doubt Rule 905 would have been introduced had the distribution compliance period circumscribed the holding period all along.

While we would support shortening the distribution compliance period to six months if Rule 905 is also eliminated, we would prefer to have the distribution compliance period remain at one year if this would result in the elimination of Rule 905.

If Rule 905 remains in place then we would very much appreciate clear guidance as to the circumstances in which it will apply especially after the lapse of the distribution compliance period. Without such guidance market uncertainty will continue. This uncertainty would undermine the policy goals behind the New Release.

We welcome your comments. Thank you for proposing constructive changes to Rule 144, and thank you for your consideration.

Sincerely,

/s/ Allen Hanen  
Allen Hanen  
Managing Partner, Moscow  
Herbert Smith CIS LLP

