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News Release

REDEFINING "PUBLIC OFFERING OR DISTRIBUTION" FOR TODAY

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Redefining "Public Offering or Distribution" for Today *

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Today, I'd like to discuss briefly a concept the Division is currently reexamining because it underlies many of the day-to-day interpretive issues and principal rulemaking efforts on our agenda. I'd like to share with you a few thoughts midstream on where we seem to be heading. This is the concept of what constitutes a distribution or public offering requiring registration under Section 5 of the Securities Act of 1933 ("Securities Act").

Since the adoption of the Securities Act -- when perhaps one could know a public offering when one saw it -- there have been significant changes altering the regulatory picture:

- the terrific growth in the trading markets,
- the increasing sophistication, complexity and diversity of financing techniques,
- the extension of the reporting requirements of the Securities Exchange Act of 1934 ("Exchange Act") to over-the-counter equities ("OTC") and the redefinition of Exchange Act disclosure obligations to parallel Securities Act requirements,
- instant communications and the revolutionary effects of technology,
- but most importantly the institutionalization and internationalization of the world's capital markets which have blurred the lines and resulted in a maze of regulatory and judicial analyses.

Indeed, over time, specific derivative issues have taken on a life of their own and have been addressed separately - each on their own concerns and specific facts.

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* I am indebted to Jan Aalbregtse and Ken Wagner, attorneys in the Division of Corporation Finance, for their help in preparing this speech.

These issues have run the gamut from

a) what constitutes a private placement?

- an offer to a limited number of sophisticated persons;

- sales to an unlimited number of accredited investors - what about offers;

- offers and sales to 35 individuals?

b) what is a general solicitation and what purpose does the concept serve in the regulatory scheme?

c) when can privately placed securities be resold?

d) what is investment intent; is it requisite to a valid private placement?

e) can you have concurrent private and public offerings of the same securities - or different securities as part of the same financing - how concurrent do offerings have to be to be integrated?

f) can you have a private placement of securities in the U.S. as part of a public offshore offering?

g) can you sell unregistered securities offshore - and to whom?

h) when can you resell securities sold abroad back into the U.S.?

i) when can dealers begin to purchase securities in foreign markets for resales to their customers following a distribution abroad?

j) when can foreign securities be placed in an ADR facility following a distribution abroad?

k) and, where <u>does</u> one find "Section 4(1-1/2)"?

These issues have been with us for the past 50 years and continue to demand constant attention as markets, financing techniques and technology increasingly accelerate to outdate specific analyses and procedures that have been developed for earlier, simpler financial environments. For example, since the adoption of Regulation D in 1982, there has been a substantial increase in primary offerings of restricted securities. In 1981 some $12 billion of securities were offered by issuers in private placements. This has grown so that in 1985, only four years later, securities totaling almost $55 billion were offered under Regulation D alone. This increase in private placement activity has resulted in the creation of a large secondary market for restricted securities. In 1983, annual trading volume in this market was estimated at $2-4 billion. 1/ The comparable 1986 volume will exceed $10 billion. 2/

This tremendous increase in the size of the markets for restricted securities focuses increasing attention on resale issues. For many years, purchasers of restricted securities have resold those securities in reliance on the exemption from registration provided by Section 4(1) of the Securities Act. Prior to promulgation of Rule 144, the SEC staff, in granting no-action letters under Section 4(1), attempted to determine, on both subjective and objective bases, whether a person had "taken with a view" to distribution. The staff based these pre-Rule 144 rulings on how long the securities had been held. Here we're talking in terms of years. Where the holding period wasn't long enough, a "change of circumstances" was required. As a result, the staff found itself deciding some rather ridiculous, personal factual questions.

Rule 144 provided objective criteria but still required rather lengthy holding periods. It did not, however, provide any criteria for sales outside of the Rule before the holding period was met. With the adoption of Rule 144, the staff stopped issuing no-action letters and indicated it no longer would give weight to the change of circumstances concept because it failed to meet the informational objectives of the Securities Act. In response there has evolved a substantial reliance on 4(1-1/2), a phantom Securities Act exemption developed with little guidance from the Commission. 3/

1/ Trading in Private Placements, Investment Dealers Digest, April 26, 1983 at 5.

2/ Private industry estimates.

3/ For a discussion of the "exemption", see The "Section 4(1-1/2) Phenomenon: Private Resales of Restricted Securities," 34 Bus. Law. 1961 (July 1979).

Resale problems also arise in connection with the dealer's exemption in Section 4(3). For example, dealers participating in an overseas offering who purchase a portion of the offering for private placement in the U.S. encounter problems. Other examples pointing up the problem: a dealer participates in private placements to a limited group of institutions and agrees to buy back the securities on request and place them with other members of the original purchasing group; or broker-dealers simply purchase restricted securities as principal for later resale. In each of the above situations, neither Section 4(1) nor Section 4(2) is literally available. Accordingly, the dealer must rely on the Section 4(3) exemption, which is available only if there is no public offering involved, and the securities sold are not part of an unsold allotment in a distribution.

Resales made on the bases of Section 4(1), "Section 4(1-1/2)" or Section 4(3) exemptions require reliance on opinions of counsel, as no defined standards have been articulated for determining when a "distribution" occurs. Other problems have arisen for lack of a clear conceptual foundation for distribution analyses.

For many years, a concept known as the "presumptive underwriter" doctrine existed. That doctrine assumed that a purchaser of a relatively large amount of securities covered by a registration statement (at one point 10%) was buying with a view to distribution and, therefore, should be deemed a statutory underwriter. The theory was most subjective, most difficult of explication and presented considerable problems both in compliance, as well as administration. In 1983, in the American Council of Life Insurance letter 4/ the presumptive underwriter doctrine was for all intents and purposes abandoned. The letter recognized that institutional investors generally should not be deemed underwriters simply on the basis of the purchase of large amounts of registered securities. The purchase of large amounts of securities was, after all, the institution's day-to-day business. Nothing in the Securities Act compelled the view that a person acquiring a substantial part of an offering should be treated differently from any other investor with a large position in the issuer, unless the purchaser becomes an affiliate as a result of the purchases.

Even various facets of integration issues seem to have become unnecessarily confused for lack of a clear conceptual

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4/ American Council of Life Insurance, May 10, 1983.

view of distribution. For instance, a valid private placement is made; subsequent thereto a public offering occurs - should there be any question as to the continuing validity of the earlier private placement? 5/ Of course not. And, it should be clear why recent structured financings involving side-by-side private and registered offerings do not require integration. In these cases, for example, a single purchaser - a financial institution - buys the entire unregistered senior debt; the senior subordinated unregistered debt is sold to 10 insurance companies and the subordinated debt offered to the public is registered. The validity of the non-registered offering should be clear but, unfortunately, it is not under current law.

Perhaps it is time to step back from the individual issues and questions of specific procedural detail and attempt to articulate a fundamental definition of a public offering or distribution requiring registration. The Division is currently attempting to do just that. Notwithstanding the variety of the analyses applied to specific distribution - related questions, and the answers given at any particular time, each seems to reflect a judgment as to whether in the particular case the persons to whom the securities were sold needed the protections afforded by Section 5. This judgment underlies the accredited investor concept in Section 4(6) of the Securities Act and Regulation D, the Rule 146 "sophisticated investor", and the numerous cases where no public offering was found on the basis of the nature of the investors.

Why not simply define a public offering or distribution subject to Section 5 registration obligations as an offering of securities to those persons who require the protections of the mandated disclosure of the registration process - specifically the individual, financially unsophisticated investor in the retail market, within the U.S. capital markets. Conversely, sales of securities to institutional, professional investors could explicitly be recognized as outside the necessary protections of the Securities Act and thus be permitted, either in direct sales from an issuer, or upon resale, to proceed without Section 5 implications.

Such a concept is certainly not novel nor is it revolutionary. The Uniform Securities Act and state blue sky laws have for many years contained an exemption for both primary and secondary

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5/ Verticom, Inc., February 12, 1986.

sales to certain financial and other institutional investors. 6/ A number of states which have adopted the Uniform Act have expanded the coverage of the institutional exemption to include corporations that meet specified net worth or asset tests, as well as specified not-for-profit entities. 7/

6/ Section 402(b)(8) of the Uniform Securities Act of 1956 provides an exemption from registration for "any offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension or profit-sharing trust, or other financial institution or institutional buyer, or to a broker-dealer, whether the purchaser is acting for itself or in some fiduciary capacity."

The Uniform Securities Act of 1985, which has yet to be adopted by any jurisdiction, contains an exemption similar to that in the 1956 Act. Section 402(10) of the 1985 Act provides an exemption for "an offer to sell or sale of a security to a financial or institutional investor or to a broker-dealer." The 1985 Act defines the term "financial or institutional investor" as including, in addition to those institutions enumerated in the 1956 Act, "an employee pension, profit sharing, or benefit plan if the plan has total assets in excess of $5 million, or its investment decisions are made by a named fiduciary, as defined in the Employee Retirement Income Security Act of 1974, that is either a broker-dealer registered under the Securities Exchange Act of 1934, an investment adviser registered or exempt from registration under the Investment Advisers Act of 1940, a depositary institution, or an insurance company."

7/ For example, Wisconsin has by rule expanded the exemption to offers or sales to "(a) an endowment or trust fund of a charitable organization specified in Section 170(b)(1)(A) of the Internal Revenue Code; (b) an issuer which has any class of securities registered under Section 12 of the Securities Exchange Act of 1934, and any wholly-owned subsidiary thereof; (c) any other corporation, partnership or association which has been in existence for 10 years or whose net assets exceed $500,000, and whose principal purpose as stated in its articles, by-laws or other organizational instrument is investing in securities . . . ." Wis. Sec. Comm'n R. 202(4), 3 Blue Sky Law Rep. (CCH) ¶64,512. Maine has expanded the exemption to include non-profit entities as described in Section 501(c)(3) of the Internal Revenue Code with total assets in excess of $5 million. Maine Rev. Stat. Ann. §§ 10501(4) and 10502(1)(I).

The ALI Federal Securities Code achieves the same result in a manner conceptually closer to that which the Division is considering. Rather than create an exemption for sales to institutions, the Code simply excludes such sales from the definition of distribution. Under the Code, a distribution does not include a "limited offering" of securities, i.e., an offering to institutional investors (including resales to the institutions) and not more than 35 other persons. 8/ "Institutional investor" is defined by the Code to include primarily financial institutions. 9/ The Code would, however, give the Commission authority to designate by rule other persons as "institutional investors." 10/

The securities laws of other countries have taken a similar view toward sales to institutional and other sophisticated investors. Under the new Financial Services Act, a person offering unlisted securities in the United Kingdom would not have to register the offering where offers are made only to persons who by rule are deemed to be "sufficiently expert to understand any risks involved." 11/ In Canada, the laws of several of the provinces contain some type of trading exemption for sales to certain types of institutional investors. Most of the provinces exempt sales to institutions such as chartered banks, registered or approved trust companies, licensed insurance companies, and registered or licensed loan companies. 12/

8/ ALI Federal Securities Code § 202(41).

9/ ALI Federal Securities Code § 202(74) defines "institutional investor" as including "(A) a bank, insurance company, or registered investment company, a fund, trust, or other account with respect to which a bank or insurance company has investment discretion, or a person who controls any such person, except to the extent that the Commission provides otherwise by rule with respect to any such class of persons on the basis of such factors as financial sophistication, net worth, and the amount of assets under investment management, or (B) any other person or class of persons that the Commission designates by rule on the basis of such factors."

10/ *Id.*

11/ Financial Services Act of 1986 § 160(6).

12/ *See generally* Can. Sec. L. Rep. (CCH) ¶3150.

The second element of the distribution concept under study - that the sales take place in the U.S. capital market - would involve some change in current positions. Over 20 years ago, Release 4708 articulated the principle that an offering by a U.S. company would be exempt from Section 5 if it was made in a manner designed to assure that the securities came to rest abroad. This interpretation has also been repeatedly reflected in no-action letters involving offshore sales by foreign corporations concerned with application of the Securities Act because of their use of interstate commerce or concern that securities would flow into the U.S. as a result of a previous U.S. market. The Commission's 4708 position was based on the view that the registration requirements of the Securities Act are primarily intended to protect American investors. A corollary of this view, however, evolved - holding that distributions expected to flow into the hands of American investors or directed toward American nationals abroad were not exempt, even though the offering and sale took place in a foreign market.

At first, the problems of sales to U.S. citizens abroad and flow-back into the U.S. were reasonably simple because the interest equalization tax deterred U.S. investors from purchasing foreign securities. Most U.S. corporations used foreign subsidiaries to sell their securities (primarily debt) abroad to avoid imposition of a withholding tax on the interest paid.

When the interest equalization tax was repealed and withholding tax laws changed, extensive procedures were imposed to assure the offshore securities weren't sold to U.S. investors. These procedures developed through the no-action letter process and are currently the source of significant comment from the securities industry. Nonetheless no conceptual analysis has been undertaken or objective standards defined in this area. The _Singer_ _13/_ and later _Procter & Gamble_ _14/_ letters have generally been relied on as the guidelines for sales of debt securities, while the procedures for the offshore sale of equity securities of a U.S. company or a foreign issuer with a U.S. market are not as well developed. _15/_ While the _Singer_ and _Procter & Gamble_ letters provide some guidance for the offshore sales, they carefully state that no position is taken as to when the securities can be sold back into the U.S., that is, when the distribution is complete.

_13/_ Singer Company, July 20, 1971.

_14/_ Procter & Gamble Co., February 21, 1985.

_15/_ InfraRed Associates, Inc., September 13, 1985.

Thus, questions arise daily about the legality of sales into the U.S., made directly, through an American Depository Receipt ("ADR") facility or following a purchase by a dealer in a foreign market. Are they in violation of Section 5 because the seller is an underwriter? I should note these are not issues of the Securities Act's jurisdictional limits. The Commission has consistently taken the position that the transnational reach of the securities laws is limited only by the conduct, effects and territoriality principles of international law. But the analysis does not end there.

While antifraud jurisdiction should be followed to its furthest possible reaches, extension of a regulatory scheme depends on statutory purpose and intended scope of the process. Perhaps it was appropriate before the Euromarket, London, Japan and others evolved into major markets, for the Commission to suggest that securities offered to a U.S. citizen anywhere in the world should comply with the Securities Act. But if this was ever warranted, it surely is not today. It would seem appropriate - and certainly required by comity with those jurisdictions in which these financial markets operate - to recognize the laws of such markets. As investors may now choose their markets, so too should they have to accept the laws applicable to, and rights afforded them, by such markets. Clearly, offerings made abroad to avoid Section 5 but intended to result in a U.S. retail distribution should still be subject to registration obligations. How to prevent such evasion is the challenge; a particularly difficult one with computerized trading, market linkages and reliance on depositories.

The British and Japanese securities laws contain different standards of applicability and provide an interesting comparison of approaches to the jurisdictional issue. The British laws apply to any offers and sales (as well as the distribution of written offering material) made in Great Britain. 16/ They do not provide protections to citizens of the U.K. who purchase securities outside of the U.K.

In contrast, it is our understanding that Japanese law depends on the location of jurisdictional acts and on residence of the offeree. Jurisdiction extends to offers and sales within Japan and to residents of Japan (including residents

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16/ Financial Services Act 1986 §§ 159, 160.

temporarily out of the country) but not to Japanese citizens residing abroad.

If the concept of defining a public offering or distribution in terms of the nature of the purchasers and the place of sale is adopted, many of the issues which are the subject of current inquiry would be addressed. They would include those stemming from the concern that immediate resales of securities intended at the time of acquisition from the issuer would in and of themselves make one an underwriter with Section 5 obligations.

A number of specific issues must be addressed. First, what is the appropriate definition of the institutional, professional market? I myself prefer the Blue Sky, ALI Federal Securities Code approach of an objective institutional criteria rather than the subjectiveness of the case law approach. The benefits of a clear bright line seem to me to outweigh the costs of limiting the class to institutions.

A second issue, particularly where equity securities with an existing market are involved, is how to deal with the fungibility problem.

A third and particularly difficult issue is how to define U.S. sales and resales - given the linkages of markets and the ability to acquire securities immediately from any of the major markets. How do you construct an effective but not unduly burdensome mechanism to assure that overseas primary offerings, particularly where there is an existing U.S. market, are not simply evasions of Section 5?

The final element in completing the conceptual foundation of the public offering or distribution standard for Section 5 purposes - is defining the "come to rest" standard. That is - when may securities sold outside the registration process in the U.S. or sold overseas be freely resold in the U.S. retail market?

Currently what rules there are, are all over the lot:

a) Rule 144 begins to permit sales after 2 years and provides for wholly free resale after 3;

b) Section 4(3) suggests a concern for 90 days following an initial public offering or 40 days after other sales;

c) Eurobonds are generally locked up for 90 days;

d) A one year lockup on a Euroequity where there was no U.S. market has been accepted;

e) Rule 147 provides for a 9 month period; and

f) Integration safe harbors key off 6 months.

We've not yet started to wrestle with this issue.

However, it is likely that an important factor will be whether the issuer is an Exchange Act reporting company. With the adoption of the integrated disclosure system and Rule 415, the Commission firmly endorsed the approach of Milton Cohen and the ALI Code in focusing on the registration of issuers into a continuous reporting process. If Exchange Act disclosure equivalent to that required by the Securities Act is available, are not investors purchasing in the secondary market assured the disclosure mandated through the registration process? Should investors trading on the exchanges or in NASDAQ traded securities have an expectation of Securities Act rights or would such rights simply be a windfall?

In attempting to rely on specific objective time periods to address the coming to rest concept the volatility of the markets and the velocity of trading will have to be taken into account. Is it fair to ask whether the 2 or 3 years used in Rule 144 has been outdated by changes in the financial markets in the 1980's?

Ontario has adopted an approach that focuses on these factors. There, resales of securities initially sold in exempt transactions are permitted based on the issuer being a reporting company, and the securities having been held for prescribed periods ranging from 6 to 18 months. The shorter periods are available for securities traded on the stock exchange or of a high grade. 17/

A wide range of questions remain and as the foregoing makes clear, our thinking is still in the conceptual, questioning phase. But, clearly, there is a need to address these issues - institutionalization, internationalization and technology compel recognition of the changes in the financial markets. We are indeed fortunate that there is already in place the registration and reporting system provided by the Exchange Act. It can, as it has in the past, assure the goals of investor protection and disclosure goals, while we continue the modernization of the capital formation process necessary to remain competitive in the world financial markets.

Thank you.

17/ Ontario Securities Act §§ 71(4) and (5).