III. SEC Staff Interpretations on Foreign Private Issuers, Regulation S, and Rule 144A

On December 8, 2016, the Securities and Exchange Commission's (SEC) Division of Corporate Finance released Compliance and Disclosure Interpretations (C&DIs) to provide guidance about assessing whether a corporation is a foreign private issuer (FPI), whether a natural person is considered a U.S. person for the purposes of the Regulation S safe harbor, and who qualifies as a qualified institutional buyer (QIB) for the purposes of the Rule 144A safe harbor.[277] C&DIs are interpretations which reflect the SEC staff's opinions, and while they "are not rules or regulations of the SEC, they are helpful to potential participants in Rule 144A and Regulation S offerings."[278] Rule 144A deals with unregistered offerings and sales of securities, and Regulation S contains two safe harbors that allow issuers to offer and sell unregistered securities deemed to be offered in another country and the resale of those securities.[279]

Particularly, the SEC staff first provided clarification for FPIs about the ownership test, the residence or citizenship of directors and executive officers, the location of assets, and the location where a business is principally administered.[280] Second, to determine whether a natural person is a U.S. person, the staff stated "the same factors should be considered as in the analysis of whether shareholders are US residents for purposes of the foreign private issuer definition."[281] Finally, the SEC provided clarification about the criteria necessary for an entity to qualify as a QIB for the purpose of the Rule 144A safe harbor to resell unregistered securities.[282] These interpretations

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[277] *See generally Sec. Act Rules*, U.S. SEC. & EXCH. COMM'N (last updated Apr. 19, 2017), https://www.sec.gov/divisions/corpfin/guidance/securitiesact-rules-interps.htm [https://perma.cc/3PRZ-GDLR].

[278] Tarik Brooks & Sujata P. Wiese, *What's Your Status? SEC Staff Releases New Interpretations on Rule 144A QIB Status and Regulation S Matters*, DRINKER BIDDLE (Jan. 6, 2017), http://www.drinkerbiddle.com/insights/publications/2017/01/whats-your-status [https://perma.cc/44WD-SFPZ].

[279] *Id.*

[280] Jonathan Handyside, *SEC Staff Releases New Interpretations Relevant for Foreign Private Issuers and Rule 144A,* SHEARMAN & STERLING (Dec. 12, 2016), http://www.shearman.com/en/newsinsights/publications/2016/12/sec-new-interpretations-for-rule-144a [https://perma.cc/XXZ8-EQDT].

[281] *Id.*

[282] *Id.*

aid individuals and entities in the process of assessing their status under U.S. securities laws, which "provide[s] welcome certainty for companies seeking to establish a US listing or maintaining an existing one."[283]

This article outlines the key explanations provided by the SEC staff in the C&DI regarding the FPI definition, Regulation S, and Rule 144A. Section A provides a brief history of the purpose of the SEC and how its mission is accomplished through the execution and implementation of the rules discussed in the C&DI. Then, Sections B, C, and D examine each rule in turn, assessing the staff interpretations and the implications of the interpretations. Finally, Section E concludes by discussing the current law and how issuers and investors are helped or harmed by the SEC interpretations.

A. Brief History

Since the creation of the SEC in 1934, its mission has been to protect investors, create public trust in the markets, and allow for the efficient transfer of capital.[284] In order to fulfill the third objective of its mission, the SEC has encouraged foreign companies to issue securities in the U.S. capital markets by making significant regulatory accommodations to corporations that qualify as FPIs under the Securities Act Rule 405 and the Exchange Act Rule 3b-4(c).[285] However, by providing certain accommodations, including limiting the necessary amount of disclosure FPIs must provide to domestic investors, there is an increased risk to investors.[286] In order to protect investors and make sure only qualifying FPIs are able to access U.S. capital markets, it is important that foreign corporations can predict their status with certainty, as "some of the disclosure accommodations that we provided to foreign private issuers almost 30 years ago

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[283] *Id.*

[284] *Securities Act Rules*, *supra* note 1.

[285] *See Are You a Foreign Private Issuer?*, CORP. FIN. ALERT (Skadden, Arps, Slate, Meagher & Flom LLP, New York, N.Y.), Jan. 2014, at 1 https://www.skadden.com/newsletters/Corporate_Finance_Alert_Are_You_a_Foreign_Private_Issuer.pdf [https://perma.cc/8MQW-BAP9]. *See generally* 17 C.F.R. § 230.405 (2016); § 240.3b-4(c).

[286] *See* Foreign Issuer Reporting Enhancements, Securities Act and Exchange Act Release Nos. 33-8959; 34-58620; International Series Release No. 1310; File No. S7-05-08, 73 Fed. Reg. 58,300 (Oct. 6, 2008).

may no longer be appropriate or necessary in light of global market developments and advancements in technology."[287]

However, there are slightly different principles underpinning the Securities Act Rule 144A that was approved by the SEC in 1990.[288] The reason for the adoption of Rule 144A was to create "a more liquid and efficient institutional resale market for unregistered securities."[289] Although Rule 144A may create greater risk for the investor because the securities are not registered with SEC allowing for limited disclosure from the issuer, there is a belief that "certain institutional investors are sophisticated enough to understand the complexities and risks inherent in private placement securities."[290]

Also in 1990, the SEC adopted the Regulation S "as a safe harbor from the registration requirements of the Securities Act for offshore offers and sales of securities."[291] Regulation S was another provision adopted to increase liquidity and efficiency during the transfer of capital in the market, but in 1998 it was observed that abuse of the provision was widespread, and that Regulation S had "been used as a means of perpetrating fraudulent and manipulative schemes, especially schemes involving the securities of thinly capitalized or 'microcap' companies."[292] The interpretations publicized by the SEC staff align with the SEC's goal of improving investor protections while continuing to allow for the efficient transfer of capital.[293]

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[287] *Are You a Foreign Private Issuer?*, *supra* note 9, at 1 ("Given the significant accommodations afforded to foreign private issuers under U.S. securities laws, it is critical that companies be able to evaluate with precision their status.").

[288] GENTI DROBONIKU, CAL. DEBT & INV. ADVISORY COMM'N, CDIAC NO. 13-05, ISSUE BRIEF: RULE 144A SECURITIES 1 (2013), http://www.treasurer.ca.gov/cdiac/issuebriefs/201307.pdf [https://perma.cc/8CUY-V2B9].

[289] *Id.*

[290] *Id.*

[291] Final Rule: Offshore Offers and Sales (Regulation S), Securities Act Release No. 33-7505; 34-39668; File No. S7-8-97; International Series Release No. 1118 (Feb. 17, 1998), https://www.sec.gov/rules/final/33-7505.htm [https://perma.cc/B9T5-59TK].

[292] *Id.* ("These types of securities are particularly vulnerable to fraud and manipulation because little information about them is available to investors.").

[293] *See id.*

B. Foreign Private Issuers

1. Definition and Interpretation

Under Securities Act Rule 405 and Exchange Act Rule 3b-4(c), the term FPI is defined as:

> [a]ny foreign issuer other than a foreign government except an issuer meeting the following conditions as of the last business day of its most recently completed second fiscal quarter: (i) More than 50 percent of the outstanding voting securities of such issuer are directly or indirectly owned of record by residents of the United States; and (ii) Any of the following: (A) The majority of the executive officers or directors are United States citizens or residents; (B) More than 50 percent of the assets of the issuer are located in the United States; or (C) The business of the issuer is administered principally in the United States.[294]

The SEC staff released specific interpretations in regards to the ownership requirement, the U.S. citizenship or residence of directors and executive officers requirement, and the determination of the location of assets and where a business is principally administered.[295]

For the purpose of assessing the ownership test, the SEC staff responded to questions regarding how an issuer calculates the 50 percent of outstanding voting securities when it has issued multiple classes of voting stock with different voting rights, as well as what factors should be used for determining whether an individual qualifies as a U.S. resident.[296] When a potential FPI "has multiple classes of voting stock with different voting rights," it may choose between two different approaches.[297] The first option is to assess whether 50 percent of the voting securities are owned by U.S. residents by combining all of the multiple classes of securities.[298] The second option is to make the assessment "based on the number of voting securities."[299]

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[294] 17 C.F.R. § 230.405 (2016); § 240.3b-4(c).
[295] Handyside, *supra* note 4.
[296] *Securities Act Rules*, *supra* note 1.
[297] Handyside, s*upra* note 4.
[298] *Id.*
[299] *Securities Act Rules*, *supra* note 1.

The opportunity to choose between these approaches gives foreign entities greater flexibility when trying to satisfy the requirements of an FPI.[300] The SEC staff also provided clarity regarding the factors necessary to determine the residence of the individuals owning the securities. It stated that as long as the issuer consistently applied criteria, such as "tax residency, nationality, mailing address, physical presence, the location of a significant portion of their financial and legal relationships, or immigration status," and did not adjust the criteria to achieve a desired result, individuals other than permanent residents may be deemed U.S. residents.[301] Additionally, the SEC staff stated permanent residents, are presumed to be U.S. residents.[302]

On the topic of U.S. citizenship or residence of directors and executive officers, the SEC was asked whether the majority calculation must be made separately for both groups or aggregated, and what the implications of a company having two boards of directors were.[303] In response, the SEC staff made clear that the assessment "must be made separately for each group" and that the calculation requires four inquires.[304] The four inquiries consist of: "the citizenship status of executive officers, the residency status of executive officers, the citizenship status of directors, and the residency status of directors."[305] If the company has two boards, then the company must assess which board "performs the functions most closely to those undertaken by a U.S. style board of directors," and if the boards split that function, then "the [FPI] may aggregate the members of the both boards for purposes of calculating the majority."[306] For companies with multiple boards, the SEC staff interpretation is extremely helpful because it specifies the particular analysis that must be undertaken. However, there is likely to be significant debate about which board functions are most like a U.S. style board, and foreign entities will be forced to

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[300] Timothy Ho, *Foreigners Get Special Treatment: SEC Updates Guidance to Foreign Private Issuers*, JD SUPRA (Jan. 4, 2017), http://www.jdsupra.com/legalnews/foreigners-get-special-treatment-sec-27048/ [https://perma.cc/2A23-D29Y].

[301] *Securities Act Rules*, *supra* note 1.

[302] *Id.* ("A person who has permanent resident status in the U.S. — a so called Green Card holder — is presumed to be a U.S. resident.").

[303] *Id.*

[304] *Id.*

[305] *Id.*

[306] *Id.*

make judgment calls that may leave their FPI status uncertain and at risk of being revoked.

When assessing whether more than 50 percent of companies' assets are located in the United States, a company may "use the geographic segment information determined in the preparation of its financial statements," or any "other reasonable methodology" for determining the amount and location of assets.[307] With the flexibility FPIs have when deciding how to file their financial statements with the SEC, the current location of assets rule gives them a variety of ways to determine the location of their assets.[308] Since FPIs are not required to continuously check their status and are allowed to choose which form to use to file their financial statements with the SEC, monitoring costs are reduced and efficiency is increased.[309]

The SEC staff also addressed the location where a business is principally administered.[310] Under the SEC staff's interpretation, there is no single factor or group of factors that is determinative when, on a consolidated basis, a company tries to determine which location its "officers, partners or managers primarily direct, control and coordinate the company's activities."[311] The SEC staff did not enumerate an exclusive list of factors to consider, but stated that multiple factors will affect the determination.[312] Overall, the interpretations by the SEC staff clarified a seemingly straightforward statute that actually relies heavily on the issuer's judgment.[313]

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[307] *Id.*

[308] *See* LATHAM & WATKINS LLP, THE LATHAM FPI GUIDE: ACCESSING THE US CAPITAL MARKETS FROM OUTSIDE THE UNITED STATES 16 (2015), https://www.lw.com/thoughtLeadership/foreign-private-issuer-guide-2015 [https://perma.cc/AA59-TP4K] ("The financial statements of foreign private issuers, however, may be prepared using US GAAP, International Financial Reporting Standards, or local home-country generally accepted accounting principles, or local GAAP.").

[309] Foreign Issuer Reporting Enhancements, Securities Act and Exchange Act Release Nos. 33-8959; 34-58620; International Series Release No. 1310; File No. S7-05-08, 73 Fed. Reg. 58,300, 58,320 (Oct. 6, 2008).

[310] *See Securities Act Rules*, *supra* note 1.

[311] Handyside, *supra* note 4.

[312] *Id.*

[313] *See* Ho, *supra* note 24 ("In summary, although the FPI definition seems clearly laid out in the statute, the actual determination of whether a company fits under each prong is often based on judgment calls that must be rational and consistently applied.").

2. Implications of the Interpretations of the FPI Definition

The increased certainty provided by the SEC staff interpretations is especially important because of the benefits and consequences that accompany being defined as a FPI.[314] Under U.S. securities law, the SEC has divided companies based on those that are domestic and those that are non-U.S. companies.[315] FPIs are a specific category of non-U.S. companies.[316] If a company qualifies as an FPI, it receives special benefits that domestic issuers do not, including the flexibility to choose how to file financial statements with the SEC, the ability to avoid quarterly reporting, and the "[a]bility to Submit IPO Registration Statements Confidentially."[317] In addition to these benefits, FPIs are exempt from proxy rules, Regulation FD, Section 16 short-swing profit rules, certain aspects of the Sarbanes-Oxley Act, and have more time to file annual reports.[318] Although these benefits only attach to a company that qualifies as an FPI, even a company that does not qualify as an FPI may access the U.S. capital markets under the rules that attach to domestic U.S. issuers.[319] Practical problems may arise though—the cost of accessing the U.S. capital market without FPI status, and the benefits that attach, may make the expense of access prohibitive.[320]

However, not everyone is comfortable with the regulatory accommodations and clarifications FPIs are receiving.[321] For example,

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[314] LATHAM & WATKINS LLP, *supra* note 31, at 16.
[315] *Id.* at 14.
[316] *Id.*
[317] *Id.* at 16.
[318] *Id.* at 17–18.
[319] *See id.* at 15 ("Once an issuer fails to qualify as a foreign private issuer, it will be treated as a domestic US issuer unless and until it requalifies as a foreign private issuer as of the last business day of its second fiscal quarter.").
[320] *See* Foreign Issuer Reporting Enhancements, Securities Act and Exchange Act Release Nos. 33-8959; 34-58620; International Series Release No. 1310; File No. S7-05-08, 73 Fed. Reg. 58,300, 58,301 (Oct. 6, 2008) ("[C]oncerns that the burdens and uncertainties associated with terminating their registration and reporting obligations under the Exchange Act could serve as a disincentive to foreign private issuers accessing the U.S. public capital markets").
[321] *See, e.g.*, *Foreign Companies Must Be Fully Accountable to U.S. Investors: Heng Ren*, STREETINSIDER.COM (Jan. 20, 2017), http://www.streetinsider.com/SI+Newswire/Foreign+Companies+Must+Be+Fully+Account-

"[c]urrently foreign private companies are given diplomatic immunity . . . They freely enter our financial markets, collect billions of dollars from investors, and even if they intentionally damaged investors, they are virtually untouchable and can head home, scot-free."[322] The SEC is trying to balance investor protection and the efficient transfer of capital, but "[s]ome FPIs exploit this legal arbitrage by hiding in this gap if they are involved in misconduct detrimental to American investors, who are increasingly investing globally via the growing number of FPIs in U.S. stock markets."[323] Based on the flexibility outlined in the SEC staff's C&DI, it appears the new interpretations will do little to tighten control on FPIs, but amendments to the rules in 2008 already targeted some of the concerns about the lack of disclosure required of FPIs.[324]

C. Regulation S

1. Safe Harbor Clarifications

In order to access U.S. markets without fully registering with the SEC, many companies utilize a combination of exemptions in order offer securities to investors inside and outside the United States.[325]

> The portion of the transaction sold to investors outside the United States will be designed to comply with the safe harbor for offshore transactions provid-

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able+to+U.S.+Investors%3A+Heng+Ren/12442776.html [https://perma.cc/6NAK-4PDK] ("Foreign companies offering securities in U.S. stock markets should be as accountable as domestic companies to U.S. laws, according to upcoming testimony by Heng Ren Partners before a committee in Washington, D.C.").

[322] *Id.*

[323] *Id.*

[324] *See* Foreign Issuer Reporting Enhancements, Securities Act and Exchange Act Release Nos. 33-8959; 34-58620; International Series Release No. 1310; File No. S7-05-08, 73 Fed. Reg. 58,300, 58,320 (Oct. 6, 2008) ("The amendments may also facilitate capital formation by foreign companies in the U.S. capital markets by enabling investors to obtain more information about these companies in a timeframe that will make the information useful to them and in a manner that will allow for greater comparability to domestic issuers.").

[325] LATHAM & WATKINS LLP, *supra* note 31, at 16 ("Global offerings that are not registered in the United States with the SEC are typically structured to take advantage of a combination of exemptions.").

> ed by Securities Act Regulation S. At the same time, the portion sold to US investors will be structured to comply with the safe harbor of Securities Act Rule 144A for resales to certain large US institutional investors known as qualified institutional buyers, or QIBs . . . .[326]

The SEC staff provided greater clarity regarding the Regulation S and Rule 144A exemptions.[327]

The Regulation S safe harbor exempts companies "from Securities Act registration requirements for certain offerings outside the United States and offshore resales of securities."[328] If the Regulation S requirements are satisfied, then the offering is considered to have taken place outside the United States, thus relieving the issuer from registration requirements.[329] Additionally, Regulation S exempts issuers from registering their securities with the SEC when offerings, "made in good faith and not as a means of circumventing the registration provisions of the Securities Act," are made outside of the United States.[330] This safe harbor is outlined in Rules 901 through 905 of the Securities Act, which provide general statements about the regulation, definitions, safe harbors, and limitations applicable to equity securities.[331]

The SEC staff interpretations specifically focused on what factors should be used to assess the U.S. Person definition under Rule 902(k)(1)(i).[332] To provide clarity and uniformity, the SEC staff stated that issuers should utilize the same assessment that is undertaken when analyzing the ownership test under the FPI definition.[333] They even outlined the same example factors to be considered and the presumption of citizenship for permanent residents.[334]

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[326] *Id.*

[327] *See supra* notes 3–4 and accompanying text (discussing how the new interpretations provide guidance on the exemptions).

[328] Handyside, *supra* note 4, at 20.

[329] *Id.*

[330] ZÉ-EV EIGER & LLOYD HARMETZ, MORRISON & FOERSTER LLP, FREQUENTLY ASKED QUESTIONS ABOUT REGULATION S 1 (2017), https://media2.mofo.com/documents/faqs-regulation-s.pdf [https://perma.cc/3CZM-8HCC].

[331] 17 C.F.R. § 230.901–05 (2016).

[332] *Securities Act Rules*, *supra* note 1.

[333] *Id.*

[334] *Id.*

2. Advantages and Disadvantages of Regulation S

Since many of the same issuers are FPIs and take advantage of offshore offerings through the use of Regulation S, the interpretations limit the number of determinations an issuer must make, thus decreasing the time and expense associated with raising capital.[335] Additionally, uniformity makes it easier for regulators to assess and issuers to understand how to comply with the current rules in place.

However, there is a major concern that issuers are utilizing Regulation S offerings and Rule 144A to issue securities to the public without the proper disclosure that goes along with registration.[336] Additionally,

> one perceived drawback of a Rule 144A/Regulation S offering is the ability of the secondary Rule 144A/Regulation S trading market to absorb a large volume of equity securities. Historically, the valuation discount because of this lack of liquidity was not sufficiently offset by the benefits of the Rule 144A/Regulation S offering and the public company costs avoided.[337]

It is unlikely that these interpretations will lower costs enough to incentivize issuers to offer unregistered securities that may be at a discounted value, especially when additional monitoring costs of issuers will be required so that purchasers of their securities do not exceed certain shareholder thresholds.[338]

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[335] *See* Foreign Issuer Reporting Enhancements, Securities Act and Exchange Act Release Nos. 33-8959; 34-58620; International Series Release No. 1310; File No. S7-05-08, 73 Fed. Reg. 58,301, 58,320 (Oct. 6, 2008).

[336] *See* EIGER & HARMETZ, *supra* note 54, at 23 ("Rule 144A and Regulation S may be used by non-reporting issuers, both domestic and foreign, for common stock offerings that are sometimes referred to as "backdoor IPOs.").

[337] *Id.*

[338] *See id.* at 24 ("In addition, a non-reporting issuer that intends to rely on Rule 144A/Regulation S for offerings of its equity securities must monitor the number of its equity holders in order not to exceed the shareholder threshold of Section 12(g) of the Exchange Act and related rules amended by Titles V and VI of the Jumpstart Our Business Startups (JOBS) Act enacted in April 2012.").

D. Rule 144A

1. Qualified Institutional Buyer Definition Clarification

Rule 144A provides a safe harbor for large sophisticated buyers to trade unregistered securities with other QIBs.[339] In order to utilize Rule 144A, an issuer must make the threshold determination that the resale is in fact to a QIB.[340] This determination is critical because the resold unregistered securities lack the full disclosure that is required for registered securities and thus, it is essential that the purchaser be financially sophisticated and able to appreciate the risks involved with purchasing unregistered securities.[341] Under Rule 144A, QIB is defined as, "[a]ny of the following entities, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity."[342]

To aid issuers in that determination, the SEC staff announced that securities purchased or held on margin may be included to meet the $100 million threshold, so long as the securities were not subject to repurchase agreements.[343] Additionally, while securities lent out are included,[344] borrowed or short position securities are not considered "owned by the entity," and therefore cannot "be included in calculating whether the entity meets the threshold."[345] These interpretations are helpful to both issuers and buyers in assessing whether their ownership or investment in securities reaches the threshold necessary to receive the benefits of participating in a Rule 144A offering.[346] Qualifying institutions are entitled to purchase resold securities in private

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[339] DROBONIKU, *supra* note 12.
[340] *Id.*
[341] *See id.* ("Rule 144A is based on the idea that certain institutional investors are sophisticated enough to understand the complexities and risks inherent in private placement securities. It carved out an exception from the registration requirements of the Securities Act to enable an organization to market and sell securities through an underwriter to certain institutional buyers without registering them with SEC.").
[342] 17 C.F.R. § 230.144A(a)(1)(i) (2016).
[343] *Securities Act Rules*, *supra* note 1.
[344] *Id.*
[345] *Id.*
[346] Brooks & Wiese, *supra* note 2.

placement without having to wait for the issuer to go through the extensive process of filing a registration statement with the SEC and enduring the waiting period associated with issuing public securities.[347] In the context of the Rule 144A and Regulation S safe harbors, the ability for an issuer or institution to precisely assess the status of the entities and individuals involved in the transaction reduces the risk of destroying the safe harbor protections, facing liability for failing to file with the SEC under Section 5 of the Securities Act, and allowing purchasers to rescind their purchase of the securities.[348]

E. Conclusion

The SEC staff interpretations provided in the December 8, 2016 C&DI greatly aid foreign entities and issuers by clarifying aspects of the FPI definition, Regulation S, and Rule 144A.[349] However, the importance of those clarifications and impact they will have on securities law is yet to be fully understood. As with many rules, greater clarity reduces the risk of their violation for the entities trying to utilize the rule for the benefits that attach. Additionally, monitoring costs are reduced and companies will be able to access cheaper capital more efficiently. However, with a better understanding of the requirements, more companies may potentially try to utilize the provisions discussed to raise capital. A drawback may be that since these rules allow entities to access capital without the full gambit of disclosure to the SEC required for domestic issuers, less robust protection is provided to investors. The SEC will need to closely monitor the use of these regulations to find the right balance between protecting investors and allowing entities to access the capital markets.

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[347] *See* 15 U.S.C. § 77e (2012).
[348] *See id.*
[349] *Securities Act Rules*, *supra* note 1.
[350] Student, Boston University School of Law (J.D. 2018).