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BARRIERS TO FOREIGN ISSUER ENTRY INTO U.S. MARKETS

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I. INTRODUCTION

This paper is a summary and updating of a report we prepared as independent consultants to the New York Stock Exchange, Inc. (NYSE) in February 1991, which explored the barriers to foreign issuer listings on U.S. exchanges created by Securities and Exchange Commission (SEC or Commission) regulations.[1] The impetus for the report was the growing recognition that despite the dramatic increase in the appetite of U.S. investors for foreign securities, the ability of U.S. investors, particularly non-institutional investors, to purchase foreign securities in the United States remains extremely limited. Although the securities of more than 2000 foreign issuers were traded in the United States in 1991, only 180 of these securities were traded on a U.S. exchange and only about 260 were traded on the National Association of Securities Dealers, Inc. Automated Quotation System (NASDAQ).[2] At year-end 1991, there were 105 foreign entities traded on the NYSE, of which twenty-six were United Kingdom (U.K.) companies, the second largest number after Canada, which had twenty-seven companies listed.[3] At year-end 1992, there were 120 foreign entities traded on the NYSE; thirty were U.K. companies and twenty-eight were Canadian companies.[4] In both years, nine Japanese companies, but no German companies were listed.[5] The vast majority of foreign securities, including the securities of world class foreign issuers, are traded in the over-the-counter "pink sheets" or the

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1. *See* Roberta S. Karmel & Mary S. Head, *Report and Recommendations to the New York Stock Exchange, Inc. on Barriers to Foreign Issuer Listings* (Feb. 15, 1991) (on file with *Law and Policy in International Business*).

2. This information was supplied to the authors through a series of telephone interviews with the NYSE Research and Planning Department. *See* NYSE, NYSE Factbook (1993) (on file with the NYSE Research & Planning Dept.)

3. *Id.*

4. *Id.*

5. *Id.*

OTC Bulletin Board Display Service of the National Association of Securities Dealers, Inc. (NASD), services that do not provide real-time quotation or transaction information.

Although the SEC now permits offshore offerings by foreign issuers to U.S. institutions and has deregulated the domestic private placement market, these developments have not encouraged foreign issuers to enter U.S. markets. This situation, which disadvantages both foreign issuers and U.S. investors, underscores the importance of developing appropriate mechanisms for dealing with cross-border transactions in international equity markets. The most common approaches to regulating cross-border transactions are: (1) requiring non-U.S. securities market participants to comply with host country standards ("national treatment"); (2) creating special host country rules for them; (3) developing harmonized transnational or international standards; and (4) accepting compliance with home country regulation by way of mutual recognition.

The United States has historically been a strong advocate of national treatment and the free international movement of goods, services and capital. National treatment is the easiest way to regulate cross-border securities activity because it does not require changes in domestic regulation. Foreign and domestic investors, financial products and financial institutions are treated alike. However, national treatment may not dismantle structural barriers to free trade. Harmonization and mutual recognition may be better policies than national treatment for regulating cross-border securities activities.

As a general matter, the SEC has insisted that foreign issuers comply with the registration provisions of the federal securities laws, including the presentation of financial statements in accordance with U.S. generally accepted accounting principles (GAAP). Nevertheless, various exemptions and special rules have been designed for securities offerings by foreign issuers. Regulation S under the Securities Act of 1933 (Securities Act) permits U.S. investors to purchase unregistered foreign securities abroad.[6] Rule 144A under the Securities Act permits institutional investors to resell such securities immediately to qualified institutional buyers in the United States.[7] Furthermore, after three years, such securities may be resold in the U.S. markets by any unaffiliated investor, even though no current public information is available with respect to

6. *See* Regulation S, 17 C.F.R. § 230.901–04 (1992).

7. *See* Rule 144A, 17 C.F.R. § 230.144A (1992).

the issuer.[8] Although these exemptions may be utilized by both U.S. and foreign issuers, they were designed for offerings by foreign issuers.

A different and more long-standing exemption available only to foreign issuers is contained in Rule 12g3–2(b) under the Securities Exchange Act of 1934 (Exchange Act). Issuers eligible to rely on this exemption generally may not have their securities traded on a national securities exchange or included in NASDAQ, but their securities can trade in the pink sheet market, including the NASD's electronic pink sheets. Foreign exempt issuers are required only to furnish (not "file" with) the SEC information required to be furnished to their home country securities regulators.[9] Reconciliation to U.S. GAAP or generally accepted auditing standards (GAAS) is not required.

The SEC is vulnerable to attack for its intransigence in refusing to allow foreign issuers to raise capital or to permit foreign securities to trade in U.S. securities markets except pursuant to U.S. disclosure requirements. However, two points should be recognized. First, under the current regulatory system, foreign issuers are accorded national treatment and are requesting a relaxation of U.S. disclosure standards. Second, the United States has already fashioned special exemptions from registration and, to a lesser extent, from disclosure requirements for foreign issuers. The question is whether there is a principled basis for further exemptions or whether multijurisdictional offerings should be regulated according to some other policy. Our conclusion is that a greater accommodation of foreign issuers would benefit the U.S. capital markets.

Ideally, the issues raised by the globalization of the securities markets would help drive development of international standards for accounting, auditing and disclosure by issuers. Under such a model, a common prospectus would be developed that would set forth agreed upon international standards for all world class companies. Similarly, with international standards concerning capital adequacy, customer protection, principles of business conduct and insurance of customer accounts, financial institutions could be freely established on a worldwide basis and governed by international regulations.

The most likely body for the establishment of international accounting standards is the International Accounting Standards Committee (IASC), an arm of the International Federation of Accountants. The IASC is a private sector organization which has published for comment a

8. *See id.* § 230.144(k).

9. 17 C.F.R. § 240.12g3–2(b)(1)(i)(A) (1992).

far-reaching proposal on international accounting principles. This proposal is unlikely to be adopted for some time. However, if the SEC could be persuaded to accept IASC accounting principles as an international standard to which foreign issuers could reconcile their financial statements, and the primary European Community (EC) capital market center and Japan would impose such standards on listed companies, many existing problems regarding multijurisdictional offerings and transnational trading activities could be resolved.

Finally, mutual recognition affords financial products and financial institutions free transit across national borders. Under a mutual recognition regime, a prospectus prepared in accordance with the requirements of an issuer's home jurisdiction is accepted for securities offerings in every jurisdiction participating in an underwriting. Similarly, a financial institution licensed by and in compliance with the regulations of its home country jurisdiction has a passport to establish and sell its services in foreign jurisdictions. The U.S.-Canadian multijurisdictional disclosure system (MJDS) utilizes mutual recognition; the SEC has proposed mutual recognition for certain rights and exchange offers, but has not yet passed any definitive rules to that effect.

Our February 1991 report concluded with several recommendations for action by the NYSE and the Commission.[10] Since then, some of the recommendations proposed in the report have been advocated by the NYSE and proposed for comment or adopted by the Commission. However, the Commission has also vigorously resisted other recommendations. To the extent that developments have occurred, a discussion of these developments is included in the analysis of foreign issuer regulation contained in Part II below and summarized in the recommendations set forth in Part III.

II. SEC REGULATION OF FOREIGN ISSUERS

Foreign issuers have historically been subject to different securities registration and disclosure requirements than U.S. issuers under the federal securities laws. A brief history of the development of the current SEC registration, reporting and disclosure requirements applicable to foreign issuers is set forth below.

A. *History of Form 20-F*

Form 20-F, adopted by the SEC in 1979, is the combined registration statement and reporting form authorized for use by foreign issuers

10. Karmel & Head, *supra* note 1, at 92–115.

under the Exchange Act and the core document of the SEC's integrated disclosure system for foreign issuers.[11] The predecessors of Form 20-F were Form 20 and Form 20-K. Adopted in 1935, Form 20 was the registration statement for foreign private issuers registering equity securities under the Exchange Act.[12] Form 20-K was the annual reporting form for foreign private issuers with equity securities registered under the Exchange Act or which had a reporting obligation under the Exchange Act arising from a prior registration statement under the Securities Act.[13] Form 20 was amended in 1967 to require increased disclosure with respect to the remuneration of officers and directors and the filing of the financial statements and schedules required by Form 10-K.[14]

As amended, Form 20 required disclosure of: information concerning the issuer's country of incorporation, ownership and control; the general character of the business and any substantial changes that had occurred during the preceding five years; the character and location of principal plants and other important units; the capital shares, funded debt and other securities to be registered; exchange controls; directors' and officers' compensation; and the financial statements, schedules and accountants' certificates required by Form 10-K.[15] A comparative balance sheet for the latest and the preceding fiscal year, a statement of income for the last three years, a statement of the source and application of funds, and usually a statement of stockholders' equity and a supplementary profit and loss statement, also were required.[16] Financial statements were not required to be reconciled with Regulation S-X, but material variations in accounting principles or practices from Regulation S-X and, to the extent practicable, the effect of such variations, were required to be disclosed.[17]

In 1976, the Commission requested public comment on "means of improving the disclosure" required of foreign issuers by Forms 20 and 20-K.[18] Noting that Forms 20 and 20-K required "substantially less" information than required of domestic issuers filing Forms 10 and 10-K,

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11. *See* 17 C.F.R. § 249.220(f) (1992).

12. Securities Act Release No. 324 (Class A) (July 15, 1935).

13. Securities Act Release No. 445 (Class A) (Dec. 20, 1935). Form 20-K required foreign issuers to report on an annual basis any changes in information previously reported and to file current financial statements. *See* Exchange Act Release No. 13,056 (Dec. 10, 1976), 41 Fed. Reg. 55,012 (1976).

14. Exchange Act Release No. 8067 (Apr. 28, 1967), 32 Fed. Reg. 7853 (1967).

15. Exchange Act Release No. 13,056, *supra* note 13, at 55,013.

16. *Id.*

17. *Id.*

18. *Id.* at 55,012.

the Commission indicated that it was considering publishing for further comment proposals to amend the disclosure requirements applicable to foreign registration and reporting forms so that filings on Form 20 and Form 20-K would contain information substantially similar to filings on Form 10 and Form 10-K.[19]

The Commission suggested that the proposed amendments would make more meaningful information available to U.S. investors concerning foreign issuers, improve the domestic market for foreign securities and reduce possible competitive disadvantages between reporting domestic issuers and reporting foreign issuers.[20] Greater disclosure on Form 20 would also permit foreign issuers to use Form S-16, a short-form registration statement for rights offerings to shareholders, in which the Form 20 could be incorporated by reference.[21]

The overwhelming majority of the comments submitted to the SEC were highly critical of any proposal to increase the existing disclosure requirements of Form 20. Commentators stated that increased disclosure requirements were unnecessary and would impose "onerous" administrative burdens and expenses on foreign issuers that would deter their use of U.S. capital markets.[22]

Despite these objections, which the Commission stated "must be weighed against the economic interest of those submitting comments," the Commission in 1977 proposed a new Form 20-F, which combined Forms 20 and 20-K into a single integrated form containing information substantially similar to Forms 10 and 10-K.[23] The Commission's rationale for the proposed new form was that it would provide more timely

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19. *Id.* at 55,013. As in effect in 1976, Forms 10 and 10-K required: a description of the issuer's current or intended business, including revenues and income attributable to separate lines of business for each of the preceding five fiscal years; competitive industry conditions; dependence on a single or limited number of customers; backlog; source and availability of raw materials; importance of patents, trademarks and licenses; expenditures on research and development and description of new products; effects and cost of compliance with environmental laws; number of employees; and seasonal aspects of the business. *Id.* The forms also required: a description of parents and subsidiaries, principal security holders and the security holdings of officers and directors and executive officers; indictments, injunctions or bankruptcies involving directors and executive officers; remuneration of officers and directors, naming them individually where direct remuneration exceeded $40,000 per year; interest of management and affiliates in transactions involving the company; and pending material litigation. *Id.* In addition to other financial information, Forms 10 and 10-K required a five-year summary of operations and the company management's analysis of any material changes disclosed. *Id.*

20. *Id.*

21. *Id.*

22. Exchange Act Release No. 14,128 (Nov. 2, 1977), 42 Fed. Reg. 58,684 (1977).

23. *Id.* at 58,685.

and meaningful information to U.S. investors, while alleviating competitive imbalances between domestic and foreign reporting companies.[24] The Commission acknowledged the burdens that the new requirements would impose on foreign issuers, but stated that "it appears difficult to justify one level of disclosure for domestic securities and another for foreign securities when the standard for both is the protection of U.S. investors."[25]

The proposed new disclosure requirements again met with a barrage of criticism from foreign issuers. Commentators objected chiefly to industry segment reporting, management remuneration disclosures on an individual basis, the shortened time period for filing Form 20-F, and the preparation of English translations of documents filed on Form 6-K, the interim reporting form for foreign issuers.[26]

The Commission adopted Form 20-F in November 1979.[27] Compared to Form 20, the new form substantially increased the extent of required disclosures. In the adopting release, the Commission stated that Form 20-F represented a "significant improvement in the amount of information required of foreign issuers in the United States, placing their required disclosures on a level closer to that required of domestic issuers."[28] At the same time, in recognition of the "differences in various national laws and businesses and accounting customs [to be taken] into account when assessing disclosure requirements for foreign issuers," the Commission indicated that substantial reductions in the proposed disclosure requirements had been made.[29] The shortened time for filing Form 20-F was abandoned, the requirement for segment reporting was modified, the proposed disclosure of the business experience and general background of officers and directors, the identification of the three highest paid officers and directors and the aggregate amount paid to them was eliminated, and the requirement to disclose material transactions between the registrant and its management was conditioned on the disclosure requirements of the applicable foreign law.[30] However,

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24. *Id.*

25. *Id.*

26. Exchange Act Release No. 16,371 (Nov. 29, 1979), 44 Fed. Reg. 70,132, 70,134 (1979).

27. *Id.* at 70,132.

28. *Id.* at 70,133.

29. *Id.*

30. *Id.* Simultaneous with the adoption of Form 20-F, the Commission adopted amendments to Form 6-K, the interim reporting form used by foreign issuers. Form 6-K had previously required foreign issuers to provide the Commission with information made available to foreign security holders, but did not require the translation of such documents into English. Although the Commission proposed a requirement that all documents filed with Form 6-K be translated into

the SEC's parochialism during its adoption of Form 20-F, in ignoring the needs and concerns of foreign issuers in order to maintain its disclosure obligations for domestic issuers, evoked hostility and suspicion from foreign business interests regarding the SEC that has not entirely subsided even today.

B. *Development of Integrated Disclosure System for Foreign Issuers*

Shortly after the adoption of Form 20-F, the Commission requested comment on the feasibility of an integrated disclosure system for foreign issuers similar to the integrated disclosure system then proposed for U.S. issuers.[31] Following favorable comment, the Commission published for comment and subsequently adopted an integrated disclosure system for foreign issuers based on three simplified, short-form registration forms (Forms F-1, F-2 and F-3) and significant revisions to the presentation of financial information on Form 20-F.[32] Earlier, the Commission had adopted amendments to Form S-16 to permit foreign issuers to register rights offerings to existing security holders, provided that a copy of the issuer's latest annual report to security holders, if available in English, or a copy of its latest annual report on Form 20-F, is furnished with the prospectus.[33]

Forms F-1, F-2 and F-3 are designed for use by foreign issuers to register offerings under the Securities Act. Form F-1 which requires a traditional prospectus, is to be used by foreign issuers registering for the first time and issuers subject to SEC reporting requirements for less than three years.[34] Most of the contents of the latest Form 20-F filing must also be furnished in the Form F-1 offering document.[35]

"World class"[36] foreign issuers or foreign issuers subject to SEC

English, Form 6-K as amended required foreign issuers to furnish the SEC with English translations or English versions of material press releases and information provided to foreign securityholders. *Id.* at 70,138.

31. Securities Act Release No. 6235 (Sept. 2, 1980), 45 Fed. Reg. 63,693 (1980).

32. Securities Act Release No. 6360 (Nov. 20, 1981), 46 Fed. Reg. 58,511 (1981) (proposing release); Securities Act Release No. 6437 (Nov. 19, 1982), 47 Fed. Reg. 54,764 (1982) (adopting release).

33. Securities Act Release No. 6156 (Nov. 29, 1979), 44 Fed. Reg. 70,131 (1979).

34. *See* 17 C.F.R. § 239.31 (1992).

35. *See* Registration Statement Under the Securities Act of 1933, Form F-1, pt. I, item 11, Fed. Sec. L. Rep. (CCH) ¶ 6951, at 6953 (Apr. 7, 1993).

36. The concept of "world class issuer" refers to "foreign private issuers that have an equity float of at least $500 million, at least $150 million of which is beneficially held by U.S. residents, or that are registering 'investment grade debt securities.' " Securities Act Release No. 6360, *supra* note 32, at 58,516.

reporting requirements for at least three years are eligible to use Form F-2.[37] Instead of including the latest Form 20-F filing in the offering document, as with Form F-1, a copy of the latest Form 20-F filing may be provided to investors with the Form F-2 offering document.[38] Form F-3 is generally used by world class foreign issuers subject to SEC reporting requirements for at least three years.[39] Because current information regarding foreign issuers in this category is deemed to be readily available to the public, copies of the latest Form 20-F are not required to be delivered with the offering document, but need only be provided upon request.[40]

In adopting the foreign integrated disclosure system, the Commission also adopted two major revisions to Form 20-F, as well as certain changes in format. The section entitled "Management's Discussion and Analysis of the Summary of Operations" was amended to reflect revisions to Form 10-K and Regulation S-K that became effective subsequent to the adoption of Form 20-F.[41] A new Item 18 of the financial statements was also added.[42]

Recognizing the difficulty experienced by foreign issuers in attempting to comply with the disclosures required by U.S. GAAP and Regulation S-X, the Commission amended Form 20-F to permit the alternative use of existing Item 17 and new Item 18 in preparing financial statements.[43] Items 17 and 18 require the same basic financial statements: audited balance sheets for the two most recent fiscal years prepared on a consolidated basis, audited statements of income, stockholders' equity and cash flows for each of the three most recent fiscal years prepared on a consolidated basis, notes to the financial statements, and the financial statement schedules required by Regulation S-X.[44] Items 17 and 18 both allow financial statements to be prepared in accordance with foreign GAAP, provided that these statements include a discussion of material

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37. 17 C.F.R. § 239.32(b)(1) (1992).

38. Registration Statement Under the Securities Act of 1933, Form F-2, pt. I, item 12, Fed. Sec. L. Rep. (CCH) ¶ 6961, at 6963 (Apr. 7, 1993).

39. *See* Securities Act Release No. 6360, *supra* note 32, at 58,517.

40. Registration Statement Under the Securities Act of 1933, Form F-3, pt. I, item 12, Fed. Sec. L. Rep. (CCH) ¶ 6971, at 6973 (Apr. 7, 1993).

41. Securities Act Release No. 6360, *supra* note 32, at 58,514.

42. *Id.*

43. *Id.* at 58,515; *see also* TOUCHE ROSS INTERNATIONAL, ENTERING THE UNITED STATES SECURITIES MARKETS 11 (1992).

44. Registration of Securities of Foreign Private Issuers Pursuant to Section 12(b) or (g) and Annual and Transition Reports Pursuant to Sections 13 and 15(d), Form 20-F, pt. IV, items 17–18, Fed. Sec. L. Rep. (CCH) ¶ 29,071, at 29,724 (Oct. 28, 1992) [hereinafter Form 20-F].

variances from U.S. GAAP and Regulation S-X, and a quantified reconciliation as to material variances between net income as presented and net income under U.S. principles.[45] The difference between Item 17 and Item 18 information is that, in addition to the basic financial statements, Item 18 requires all other disclosures called for by U.S. GAAP and Regulation S-X, including information regarding income taxes, leases, pensions, nonconsolidated affiliates, borrowing arrangements, related parties, and industry segment information.[46]

Item 17 information is required for Exchange Act registration statements and annual reports on Form 20-F.[47] It is permitted for offerings of non-convertible debt securities by world class foreign issuers registered on Form F-3 and certain offerings to shareholders or employees.[48] Item 18 disclosure is required in all other offerings under the Securities Act.[49] For this reason, the Commission has urged foreign registrants, especially those eligible to use Forms F-2 and F-3, which generally incorporate the most recent filing on Form 20-F, to prepare their annual reports on Form 20-F in compliance with Item 18.[50]

C. *Current SEC Registration and Disclosure Requirements*

1. *Securities Act Registration.* To register a class of equity securities under the Securities Act, a foreign company may utilize Forms F-1, F-2, F-3 or F-4 (for certain business combinations).[51] (Foreign issuers that are required to file or voluntarily file Forms 10, 10-K, 10-Q and 8-K must file Forms S-1, S-2 or S-3 in the integrated disclosure system for U.S. issuers.)[52] Except for non-convertible debt offerings on Form F-3, financial statements must be prepared in accordance with Item 18 (requiring compliance with U.S. GAAP and Regulation S-X).[53]

2. *Exchange Act Registration.* Unless an exemption is available under Rule 12g3–2(b), discussed below,[54] a foreign issuer with more than 300 U.S. shareholders, provided that it has more than 500 shareholders

45. Securities Act Release No. 6360, *supra* note 32, at 58,515.
46. *See id; see also* TOUCHE ROSS INTERNATIONAL, *supra* note 43, at 12.
47. Securities Act Release No. 6360, *supra* note 32, at 58,515.
48. *Id.*
49. *Id.*
50. *Id.* at 58,515 n.34.
51. Securities Act Release No. 6437, *supra* note 32, at 54,765.
52. *Id.*
53. *Id.*
54. *See infra* part II.C.3.

worldwide and total assets in excess of $5 million, is required to register its equity securities pursuant to Section 12(g) of the Exchange Act.[55] A foreign issuer that wishes to become listed on a U.S. exchange is required to register under Section 12(b) of the Exchange Act.[56] To register under Sections 12(b) or (g), a foreign issuer must file a registration statement on Form 20-F.[57] Thereafter, the issuer must file an annual report on Form 20-F within six months after each year-end and a Form 6-K to report interim financial results and certain other events.[58] Foreign issuers subject to reporting requirements under the Exchange Act as a result of a previous Securities Act offering may also file annual and interim reports on Forms 20-F and 6-K.[59]

Annual reports on Form 20-F may be prepared on the basis of Item 17 information, which does not require full reconciliation to U.S. GAAP.[60] However, because Item 18 information is required in connection with most offerings of equity securities under the Securities Act, and because the forms for registering offerings under the Securities Act are based on Form 20-F, it is necessary for foreign issuers contemplating future equity offerings to prepare annual reports on Form 20-F in accordance with Item 18 and U.S. GAAP.

Pursuant to Rule 3a12–3, foreign issuers whose securities are registered under the Exchange Act are exempt from the proxy solicitation and information statement provisions of Section 14 of the Exchange Act and the short-swing trading profits provisions of Section 16.[61] Such issuers are, however, subject to the Foreign Corrupt Practices Act and their registered equity securities to the tender offer provisions of the Exchange Act.

3. *Exchange Act Rule 12g3–2(b).* Exchange Act Rule 12g3–2(b), adopted in 1967, exempts the securities of a foreign issuer from registration under Section 12(g) of the Exchange Act, provided that the issuer furnishes the SEC with copies of material information made public in its local jurisdiction or sent to foreign securityholders.[62] Material furnished under the Rule 12g3–2(b) exemption is not deemed "filed" with the SEC

55. Securities Exchange Act of 1934, 15 U.S.C. § 78l(g)(1)(B) (Supp. 1992).

56. *Id.* § 12(b).

57. Form 20-F, *supra* note 44.

58. 17 C.F.R. §§ 240.13a–16a, 249.220f(a) (1992).

59. *Id.* § 249.220f(a).

60. *See* Securities Act Release No. 6360, *supra* note 32, at 58,515.

61. 17 C.F.R. § 240.3a12–3 (1992).

62. 17 C.F.R. § 240.12g3–2(b)(1) (1992).

or otherwise subject to the liabilities of Section 18 under the Exchange Act.[63]

Since 1983, the Rule 12g3–2(b) exemption has not generally been available to foreign issuers whose securities are listed on an exchange or quoted in NASDAQ. Although the exemption was originally available to foreign issuers quoted in NASDAQ, the SEC terminated the exemption for any future NASDAQ foreign issuers in 1983.[64] Foreign issuers with securities then trading in NASDAQ in reliance on the exemption were "grandfathered" by the SEC; Canadian issuers were grandfathered for two years and all other foreign issuers were grandfathered indefinitely.[65] All new foreign issuers applying for NASDAQ inclusion have since been required to become registered under Section 12(g) by filing Form 20-F.[66] As a result of the grandfathering, however, the securities of many foreign issuers continue to be included in NASDAQ on the basis of the Rule 12g3–2(b) exemption.

4. *American Depository Receipts (ADRs)*. ADRs may be registered under the Securities Act by using Form F-6.[67] To use Form F-6, a foreign issuer must comply with Exchange Act reporting requirements or obtain an exemption from such requirements pursuant to Rule 12g3–2(b).[68] Registration of the deposited shares underlying the ADRs for purposes of a public offering or an exchange listing may be accomplished by filing Forms F-1, F-2, or F-3.[69]

ADR arrangements may be sponsored or unsponsored. In an unsponsored arrangement, the ADR mechanism is typically initiated by a U.S. bank, which establishes the arrangement, generally with the knowledge, but not the active cooperation, of the foreign issuer.[70] Dividend distribution fees and other administrative costs are borne by the ADR holders through the bank's retention of a portion of the dividend.[71] A sponsored ADR arrangement is generally initiated by a foreign corporation actively seeking to broaden its shareholder base in the United States.[72] The foreign issuer pays the depository institution's fees and usually agrees to

63. *Id.* § 240.12g3–2(b)(4).
64. Securities Act Release No. 6493 (Oct. 6, 1983), 48 Fed. Reg. 46,736 (1983).
65. *Id.* at 46,737.
66. *See id.* at 46,736–37.
67. 17 C.F.R. § 239.36 (1992).
68. *Id.* § 239.36(c).
69. *See generally id.* § 239.31–33.
70. Karmel & Head, *supra* note 1, at 54–55.
71. *Id.* at 55.
72. *Id.*

provide shareholder communications through the depository institution.[73]

Pursuant to Exchange Act Rule 15d-3, annual and other reports are not required as a result of registering ADRs on Form F-6, and ADRs are exempt from registration under Section 12(g) of the Exchange Act pursuant to Rule 12g3–2(c).[74] However, to become listed on a U.S. exchange or quoted in NASDAQ, ADRs must be registered pursuant to Section 12(b) or Section 12(g) of the Exchange Act, respectively, and a registration statement and annual reports must be filed on Form 20-F.[75] As noted above, an exception to this general requirement has been made for certain non-Canadian foreign issuers quoted in NASDAQ in 1983, who were grandfathered when Rule 12g3–2(b) was amended.[76] However, the majority of ADRs, including those of many world class foreign issuers, trade in the United States in the National Quotation Bureau's "pink sheets" or the NASD's OTC Bulletin Board Display Service by virtue of the exemption under Rule 12g3–2(b).

D. *Regulatory Developments in Internationalization*

1. *Multijurisdictional Disclosure System with Canada.* One of the SEC's relatively recent initiatives in the area of internationalization has been the development of harmonized prospectus requirements with certain foreign regulators. In its 1985 concept release on "Facilitation of Multinational Securities Offerings," the SEC requested comment on various proposals to harmonize the prospectus disclosure standards and distribution systems of the United States and other countries.[77] In that release, the SEC recognized four problem areas confronting any effort to harmonize securities regulations so as to foster simultaneous offerings in several countries. These areas included the mechanics of a distribution as mandated by the operation of Section 5 of the Securities Act; differences in disclosure regarding the nature and character of the issuer, its business and management; differences in generally accepted accounting principles; and differences in liability provisions for the sale of securities.[78] The SEC proposed two ways to overcome these problems: reciprocity, whereby participating jurisdictions would accept one

73. *Id.*

74. 17 C.F.R. §§ 240.15d-3, 240.12g3–2(c) (1992). These exemptions apply only to the ADRs themselves and are not available to the underlying deposited shares. *Id.* § 240.12g3–2(c).

75. *See* Securities Exchange Act of 1934, *supra* note 55, § 12(b), (g); Form 20-F, *supra* note 44.

76. Securities Act Release No. 6493, *supra* note 64, at 46,737.

77. Securities Act Release No. 6568 (Feb. 28, 1985), 50 Fed. Reg. 9281 (1985).

78. *Id.* at 9281–83.

another's home country standards for a prospectus; and a common prospectus approach, whereby regulators would agree on disclosure standards for an offering document.[79]

Commentators strongly endorsed the SEC's initiative, suggesting that the common prospectus approach might be ideal, but was probably also impractical.[80] Despite the difficulties, the SEC proposed, reproposed and subsequently adopted an initial multijurisdictional registration experiment with the Ontario and Quebec Securities Commissions covering offerings of world class Canadian issuers, including rights and exchange offers.[81] "Substantial" Canadian companies with a three-year reporting history in Canada are permitted to use documents prepared according to Canadian securities laws to register securities with the SEC.[82] Annual and periodic Exchange Act reporting and even tender offer requirements may similarly be met with Canadian disclosure documents.

The multijurisdictional prospectus with the Ontario and Quebec Securities Commissions is a hybrid between a reciprocal and common prospectus. The multijurisdictional disclosure system (MJDS) rules permit the disclosure document for an offering to be prepared in accordance with the requirements of the issuer's home jurisdiction, with the regulatory authorities of the home jurisdiction being responsible for establishing the applicable disclosure standards.[83] Review of the documents is that customary in the home jurisdiction.[84] Issuers are subject, however, to the civil liability and anti-fraud provisions of the country of the offering.[85] Some rather complex adjustments to the regulation of stabilizing activity and tender offer mechanics also were adopted.[86]

The MJDS is a significant step toward multinational offerings and cross-border financing based on principles of comity rather than extraterritoriality. The SEC's willingness to harmonize U.S. and Canadian

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79. *Id.* at 9283.

80. The Securities Act Release No. 6841 (July 24, 1989), 54 Fed. Reg. 32,226 (1989).

81. *Id.*; Securities Act Release No. 6879 (Oct. 16, 1990), 55 Fed. Reg. 46,288 (1990) (reproposal); Securities Act Release No. 6902 [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,812 (adopting release) (June 21, 1991).

82. Companies with a total market value for common stock of CN$180 million and a public float of CN$75 million are eligible to use the F-9 registration form for investment grade debt and preferred stock offerings; companies with a market value for common stock of CN$360 million and a public float of CN$75 million are eligible to use the F-10 registration form for equity offerings. Securities Act Release No. 6841, *supra* note 80, at 32,241.

83. *Id.* at 32,227.

84. *Id.*

85. *Id.*

86. *Id.*

requirements was largely based on the similarity of U.S. and Canadian securities regulations and accounting and auditing standards as well as the existence of a Memorandum of Understanding concerning mutual cooperation in matters relating to the administration and enforcement of U.S. and Canadian securities laws.[87] Nevertheless, differences between U.S. and Canadian GAAP do exist and there are different independence standards for auditors.[88] As a result, the MJDS requires reconciliation of Canadian financial statements to U.S. GAAP for equity offerings and Exchange Act registrations.[89]

2. *Proposed Multinational Tender Offer Reform.* In June 1990, the Commission issued a concept release on a proposed regulatory framework for facilitating the inclusion of U.S. securityholders in certain transnational exchange and tender offers.[90] The impetus for the concept release was the Commission's recognition that U.S. securityholders are frequently excluded from foreign exchange and tender offers because of the high cost of compliance with U.S. securities registration and disclosure requirements. The Commission indicated its intention to remedy this problem by negotiating multijurisdictional disclosure systems with individual foreign countries.[91] As a complement to the MJDS, however, the Commission requested comment on a conceptual approach that would permit multinational tender and exchange offers to be made in the United States based on documentation prepared in compliance with foreign disclosure, procedural and accounting requirements in those cases where U.S. investors hold only a small portion of a foreign company's security holdings.[92] U.S. antifraud provisions would, of course, still apply.[93]

The Commission also requested comment on whether the concept of reliance on home country practices should extend only to those jurisdictions that provide some disclosure and procedural protections to securi-

87. *See id.* at 32,231.

88. *Id.* at 32,234–35. The original proposal would have required compliance with the auditor independence rules of the jurisdiction in which the offer was made. As adopted, the auditor's compliance with U.S. independence rules would apply only with respect to the audited financial statements for the most recent fiscal year included in the initial registration statement under the Securities Act or Exchange Act on a multijurisdictional disclosure system form. Securities Act Release No. 6902, *supra* note 81, at ¶ 84,812.

89. Securities Act Release No. 6841, *supra* note 80, at 32,226, 32,238.

90. Securities Act Release No. 6866 (1990), 55 Fed. Reg. 23,751 (1990).

91. *Id.* at 23,752.

92. *Id.* at 23,753.

93. *Id.*

tyholders, whether the concept should be applied to all tender offers involving limited U.S. holdings, regardless of foreign regulatory requirements, or whether the Commission should continue to assess the need to accommodate foreign laws and practices on a case-by-case basis.[94]

3. *Regulation S and Rule 144A.* Adjusting U.S. registration requirements to fit the needs and practices of foreign issuers and creating a common prospectus are initiatives designed to attract foreign issuers into the SEC's jurisdiction and mandated disclosure system. A quite different approach is reflected in other SEC efforts to reconcile the securities laws with internationalization, namely, the exemption of foreign offerings from registration. This approach is embodied in two rules adopted in 1990: Regulation S and Rule 144A.

(a) *Regulation S.* Regulation S is intended to clarify the extraterritorial application of Section 5 of the Securities Act.[95] Regulation S consists of a general statement providing that Securities Act registration requirements do not apply to offers and sales made outside the United States[96] and two non-exclusive safe harbors: one for issuers and securities professionals involved in the distribution process and their affiliates ("issuer safe harbor") and the other for resales by all other persons ("resale safe harbor").[97] In addition to the specific requirements of each safe harbor, two general conditions apply to all offers and sales made in reliance on Regulation S: the offer and sale of securities must be made in an offshore transaction, and directed selling efforts in the United States are prohibited.[98] To qualify as an offshore transaction, offers may not be made to persons in the United States and either (1) the buyer is (or the seller reasonably believes that the buyer is) offshore at the time the buy order is placed; or (2) the sale is made on a foreign securities exchange (for the issuer safe harbor) or through a designated offshore securities market (for the resale safe harbor).[99]

The issuer safe harbor distinguishes among three categories of securities based on the nationality and reporting status of the issuer and the extent of U.S. market interest in the issuer's securities. The first category imposes no restrictions other than the general conditions that the securities be sold in an offshore transaction and that there be no

94. *Id.* at 23,754.
95. 17 C.F.R. §§ 230.901–.904 (1992).
96. *Id.* § 203.901.
97. *Id.* §§ 230.903–.904.
98. *Id.* § 230.903(a)–(b).
99. *Id.* § 230.902(i).

directed selling efforts in the United States.[100] This category applies to offerings by foreign issuers with no substantial U.S. market interest, whether or not the issuer is subject to Exchange Act reporting requirements, and to offerings by foreign issuers targeted at a single foreign country, whether or not the issuer's home country.[101]

The second issuer safe harbor applies to offerings of U.S. reporting issuers, foreign reporting issuers with substantial U.S. market interest, and offerings of debt and other securities of non-reporting foreign issuers.[102] Such offerings may not be sold to U.S. persons for forty days and are required to be made in conformity with specified offering restrictions.[103]

The third issuer safe harbor category is of use primarily for offerings of non-reporting U.S. issuers and equity offerings of foreign issuers with substantial U.S. market interest for the class of securities offered.[104] This category imposes more restrictive procedures designed to guard against flowback of securities to the United States. Equity offerings in this category may not be sold to U.S. persons for a one-year period, and debt securities are subject to a forty-day restricted period.[105] Specified offering restrictions also apply.[106]

The resale safe harbor is available to persons other than issuers, distributors, and their affiliates and imposes restrictions beyond the two general conditions only where the securities were sold by a dealer or similar person.[107] Resales on established foreign securities exchanges or organized markets are permitted.[108]

(b) *Rule 144A.* Rule 144A provides a safe harbor exemption from Securities Act registration requirements for specified resales of restricted securities to qualified institutional buyers (QIBs).[109] Rule 144A defines QIBs as institutions that in the aggregate own and invest on a discretionary basis at least $100 million in securities.[110] Registered broker-dealers, whether purchasing for their own accounts, acting as

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100. *Id.* § 230.903(c)(1).

101. *Id.*

102. *Id.* § 230.903(c)(2).

103. *Id.*

104. *Id.* § 230.903(c)(3).

105. *Id.*

106. *See id.*

107. *Id.* § 230.904.

108. Securities Act Release No. 6863 (May 2, 1990), 55 Fed. Reg. 18,306, 18,319 (1990).

109. 17 C.F.R. § 230.144A (1992).

110. *Id.* § 230.144A(a)(1). The definition of QIB was recently expanded to include collective and master trusts, and U.S. government securities were permitted to be counted towards the $100

riskless principals for QIBs or acting as agent on a non-discretionary basis, must own at least $10 million of securities.[111]

Rule 144A is applicable only to securities that, when issued, are not of the same class as securities listed on a national securities exchange or on NASDAQ.[112] In the case of ADRs listed on an exchange or quoted in NASDAQ, both the ADRs and the deposited shares underlying the ADRs are considered publicly traded. Securities of the same class as the deposited securities may not be sold in reliance on Rule 144A.[113]

Rule 144A imposes a "reasonable belief" standard on sellers with respect to the status of buyers as QIBs.[114] A seller and any person acting on the seller's behalf may rely on the purchaser's most recent publicly available annual financial statements, the most recent information in documents filed by the purchaser with the SEC or other U.S. or foreign government agency, or the most recent information about the purchaser contained in a recognized securities manual.[115] A seller also may rely on such information even if other, more recent, information indicates a lesser amount of securities owned by the purchaser.[116] Alternatively, a seller may rely on appropriate certifications from the purchaser's chief executive or financial officers.[117]

Rule 144A also imposes an information requirement where the issuer of the securities to be resold in reliance on Rule 144A is neither an Exchange Act reporting company nor exempt from reporting requirements pursuant to Rule 12g3-2(b).[118] This requirement provides the holder of the security, and a prospective purchaser, with the right to receive specified limited information about the issuer upon request.[119] However, as stated above, non-U.S. companies which furnish the SEC with financial and business information already made public in their

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million requirement. Securities Act Release No. 6963 [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,052 (Oct. 22, 1992).

111. 17 C.F.R. § 230.144A(a)(1)(ii) (1992).

112. *Id.* § 230.144A(d)(3).

113. An issuer may enter the Rule 144A market even if it has a sponsored or unsponsored ADR program, provided the class of securities offered is not listed on a U.S. exchange or quoted in NASDAQ. Nor does a Rule 144A offering of ADRs or ordinary shares preclude an issuer from subsequently registering the securities with the SEC and applying for an exchange listing or inclusion in NASDAQ.

114. 17 C.F.R. § 230.144A(d)(1) (1992).

115. *Id.* § 230.144A(d)(1)(i)-(iii).

116. Securities Act Release No. 6862 (Apr. 30, 1990), 55 Fed. Reg. 17,933, 17,946 (1990).

117. *Id.* § 230.144A(d)(1)(iv).

118. *Id.* § 230.144A(d)(4)(i).

119. *Id.*

home countries pursuant to Rule 12g3–2(b) need not comply with this requirement.[120]

Securities acquired in reliance upon Rule 144A are deemed "restricted" securities and may be resold only in compliance with the requirements of Rule 144.[121] Further, if a market for Rule 144A securities develops, it is to be expected that the number of U.S. securityholders will increase, subjecting many foreign issuers to the registration and periodic reporting requirements of the Exchange Act.

(c) *The PORTAL System.* Simultaneously with the adoption of Rule 144A, the Commission approved the NASD's Private Offering, Resale and Trading Through Automated Linkages (PORTAL) System.[122] PORTAL was designed to establish automated trading, clearance and settlement facilities for primary placements and secondary trading of unregistered securities to QIBs through the International Securities Clearing Corporation, Depository Trust Company and Centrale de Livraison de Valeurs Mobilieres, S.A. Luxembourg (CEDEL). PORTAL has not been widely used, and the NASD has proposed significant changes to its operations.[123]

F. *Summary*

As is evident from the above discussion of regulatory initiatives, the SEC is redefining its approach to the challenges of internationalization. However, as long as the SEC requires foreign issuers to reconcile financial statements to U.S. GAAP and Regulation S-X, other accommodations to foreign issuers will accomplish little. World class foreign issuers will be precluded from having their securities traded in liquid markets on an exchange or NASDAQ, and U.S. investors will find it difficult and expensive to invest in such companies.

The SEC may be bowing to reality in fashioning safe harbor exemptions from registration for foreign issuers. The development of an exempt institutional marketplace for foreign securities, whether offshore or onshore, may prove instructive in suggesting what disclosure standards are good business practice. Nonetheless, both Regulation S and Rule 144A are philosophically at odds with efforts to develop an integrated international disclosure system. Exempting transactions from the registration provisions and moving markets offshore is hardly the best way to protect either U.S. investors or U.S. securities markets.

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120. *See supra* notes 62–63 and accompanying text.

121. 17 C.F.R. § 230.144A (preliminary n.6) (1992).

122. Exchange Act Release No. 27,956 (Apr. 27, 1990), 55 Fed. Reg. 18,781 (1990).

123. *See* SEC File No. SR-NASD-91-05 (filed Jan. 28, 1991).

To facilitate the offering of foreign securities in U.S. markets and provide investment opportunities in foreign securities for U.S. investors, the SEC will have to take affirmative steps to encourage foreign issuers to list in the United States. Over the long term, the development of a single prospectus and the harmonization of international accounting standards can be expected to eliminate many of the current barriers to increased participation of foreign issuers in U.S. capital markets. However, relief for both foreign issuers and U.S. investors is urgently needed in the near term.

III. RECOMMENDATIONS

In this section, specific recommendations to facilitate foreign issuer trading and listing in the United States are discussed under conceptual headings relating to: an expanded Rule 12g3–2 exemption that would permit exempt foreign issuers to list on U.S. exchanges and NASDAQ; new exemptions for tender offers, rights offers, and employee stock plans; and wraparound registrations. Where developments have occurred since our report to the Exchange in February 1991, we have updated the discussion of our recommendations accordingly.

1. *The SEC should amend Rule 12g3–2 under the Exchange Act to permit any world class foreign issuer whose securities are traded on a principal foreign market, including listed companies, to be exempt from Section 12 of the Exchange Act.*

Currently, the exemption from registration under Section 12 of the Exchange Act provided to foreign issuers by Rule 12g3–2(b) is not available to listed companies or companies traded on NASDAQ.[124] At one time, the rationale for this distinction was that foreign issuers that do not enter the U.S. trading markets voluntarily should not be required to register their securities pursuant to Section 12 of the Exchange Act. This led to the legal fiction of permitting issuers with "unsponsored" ADR arrangements to obtain a Rule 12g3–2 exemption. However, there is no longer any meaningful distinction between sponsored and unsponsored ADR programs. Nor is there a convincing rationale for allowing ADRs or securities of exempt foreign issuers to be quoted in the electronic pink sheets, but permitting such quotes to be displayed in

124. *See* 17 C.F.R. § 240.12g3–2(d) (1992). Only securities registered under Section 12(b) of the Exchange Act are eligible for listing. For that reason, the rule we are advocating would have to be promulgated under Section 12(b) as well as Section 12(g) of the Exchange Act.

static form and updated only twice daily.[125] The use of such a stick against exempt securities does not punish the issuers as much as it punishes U.S. investors who wish to trade in these securities.

Many foreign markets are efficient and liquid, and many foreign securities provide attractive investment opportunities. Current SEC regulation forces U.S. investors who wish to trade in such securities, unless they qualify as QIBs, to do so in foreign markets at considerable unnecessary expense or to purchase foreign country U.S. mutual funds. While such funds may serve a useful purpose, most of the securities purchased by these funds are those of issuers that do not make U.S.-style disclosure or reconcile to U.S. GAAP. Many of them could not qualify for an Exchange listing. Why should investors be forced to purchase an entire portfolio of foreign securities rather than be permitted to make individual selections?

Accordingly, we propose that the Rule 12g3–2 exemption be expanded so that it is available to foreign private issuers that have ADRs or securities listed on the Exchange or traded in any other U.S. marketplace. While the SEC could create a special filing requirement for such issuers instead of expanding the Rule 12g3–2 exemption, foreign issuers attach great importance to potential liability for misleading statements under Section 18 of the Exchange Act, which a filing requirement would entail. Because even exempt issuers are subject to Section 10(b) of the Exchange Act, we believe that an exemption rather than a new filing requirement would be preferable. We recognize that the SEC may wish to condition the availability of an expanded Rule 12g3–2 exemption to world class issuers whose securities are traded on principal foreign exchanges. The Commission also may wish to provide a mechanism for disclosing to investors that the issuer does not make U.S. required disclosure or reconcile its financial statements to U.S. GAAP. We recommend that such refinements be included in the enlarged exemption.

The SEC has come to recognize the concept of a world class issuer traded on a principal foreign market in other contexts and to treat the securities of such issuers as equivalent to the securities of U.S. public companies. Under the "ready market" standard employed by the SEC in its net capital rules, certain foreign debt and equity securities of a foreign issuer that has conducted a public offering and become listed on a principal foreign market are treated as liquid securities.[126] In 1990,

125. *See* Exchange Act Release No. 27,975 (Apr. 27, 1990), 55 Fed. Reg. 19,124 (1990).

126. *See* 17 C.F.R. § 240.15c3–1(c)(11) (1992); *see also* Securities Industry Ass'n, SEC No-Action Letter, 1976 WL 9174 (SEC) at 1–2 (Jan. 29, 1976), *available in* WESTLAW, FSEC-NAL Database.

the Federal Reserve Board amended Regulation T to permit foreign world class debt and equity securities to be eligible for margin on a similar basis as U.S. margin securities.[127] The criteria necessary for determining that a foreign security is eligible for margin treatment include the following: the issuer must have been in existence for five years and the security must have been trading for not less than six months; daily quotations for both bid and asked or last sale prices must be provided by the foreign securities exchange or market and be continuously available in the United States; the aggregate market value of unrestricted market shares must be not less than $1 billion; and the average weekly trading volume of the security during the preceding six months must be at least 200,000 shares or $1 million.[128]

While these liquidity concepts are useful precedents for defining a world class security traded on a principal foreign market, we believe that the criteria for permitting Rule 12g3–2 exempt securities to be freely traded and listed in the United States should be crafted somewhat differently. The Exchange has its own standards for listing, which take into account the number of shareholders, market value of shares, earnings and assets.[129] There are also certain disclosures which must be made to the Exchange (in connection with a listing application) and to the marketplace (after listing).[130] Nevertheless, under our proposal, there could be a divergence between the initial, annual and periodic reporting requirements of U.S. and foreign companies. Such a divergence should be limited to issuers on the "First Section" or "A" (or equivalent) list of principal foreign markets, because this would take into account the fact that the foreign regulators of such issuers, to a greater or lesser extent, substitute merit regulation for full disclosure under U.S. law. Furthermore, the SEC could limit the use of an expanded Rule 12g3–2 exemption to issuers traded in a jurisdiction that has a Memorandum of Understanding with the SEC or otherwise meets criteria necessary to be a "principal foreign market."

Additionally, we believe that U.S. investors should be informed that a foreign listed company which does not have its securities registered under the Exchange Act may not make U.S.-style disclosures or fully reconcile to U.S. GAAP. This could be accomplished by requiring that an asterisk or other identification be published with publicly disseminated

127. *See* 12 C.F.R. § 220.2(i) (1990).

128. *See* NYSE Interpretation Mem. 90–9 (Nov. 9, 1990).

129. NYSE Listed Company Manual § 103.01 (1990).

130. *Id.* §§ 104.02, 202.

transaction or last sale information indicating that only foreign financial statements and disclosures are available for this issuer.[131] If U.S. investors are permitted to purchase and sell securities that are in bankruptcy proceedings in this fashion, surely they should be able similarly to trade in the securities of some of the world's biggest and most successful enterprises.

Since the antifraud provisions of the Exchange Act would apply to a foreign issuer's disclosures, the risks to investors in permitting exempt foreign issuers to list on an exchange would be minimal. Furthermore, once a foreign issuer lists and is in a position to perceive the benefits of a U.S. market for its securities, it is more likely to adapt its disclosure documents and financial statements to U.S. (or international) standards. Pressure from analysts and money managers for more information and a desire to maintain a good U.S. trading market should motivate such issuers to participate more fully in the U.S. disclosure system and to use the U.S. markets for capital raising. In the meantime, the SEC could utilize the evolution of disclosure by listed, exempt foreign issuers as an experiment to determine what type of financial and other information of foreign issuers is really material and useful to investors.

> 2. *The SEC should draft rules under Sections 13 and 14 of the Exchange Act and under the Securities Act exempting tender and exchange offers by foreign issuers from the provisions of the Williams Act and from Securities Act registration. The SEC should also adopt a rule under the Securities Act excluding a rights offer or an employee stock plan by a foreign issuer from the definitions of "offer" or "sale" for purposes of Section 5. The rule would apply only to those offers and employee stock plans in which U.S. investors hold an insignificant percentage (less than ten percent) of the securities that are the subject of the rights offer or employee stock plan.*

In its 1990 concept release on a proposed regulatory framework for multinational tender and exchange offers, the SEC acknowledged that U.S. investors have been disadvantaged by the Commission's insistence

131. Although presumably the blue chip exemption from state blue sky registration requirements would be applicable to foreign securities, simplifying federal regulation will be a futile endeavor if the states insist on reviewing foreign issuer disclosure documentation. We recognize that fraud by foreign issuers has occurred in the past and may occur again. Nevertheless, we recommend that serious consideration be given to the development of a blue chip exemption for foreign securities at the state level.

that foreign issuers comply fully with the federal securities laws in order to make a tender offer to U.S. securityholders.[132] Rather than comply with SEC requirements, foreign bidders have discriminated against U.S. investors by excluding them from tender offers.[133] While proposing new rules for the regulation of tender offers by foreign bidders is beyond the scope of this project, the Commission's release is important for two reasons. First, the SEC has acknowledged that the protection of U.S. investors in a globalized securities market may require treating some types of transnational securities transactions differently than U.S. transactions. Second, the key to such differential treatment is accepting foreign disclosure and accounting documentation as satisfactory compliance with SEC filing requirements, rather than insisting on U.S. style disclosure and reconciliation to U.S. GAAP.[134]

We recommend, therefore, that the SEC go forward with the ideas contained in its concept release on multinational tender and exchange offers, not only as to tender offers, including exchange offers, but also as to rights offers by foreign issuers, which present similar problems. In rights offers, like tender offers, where only a small percentage of a foreign issuer's securities is owned by U.S. investors, the issuer typically declines to extend the offer to U.S. securityholders and instead cashes them out, often to their economic detriment. By protecting investors against the "harm" of investing in foreign securities based on foreign disclosures and accounting information, the SEC is currently depriving investors of the full benefits of their ownership of foreign securities. Another type of transaction deserving similar special treatment involves employee stock plans, an increasingly popular form of employee incentive compensation denied to U.S. employees of foreign issuers that are not registered under Section 12 of the Exchange Act or prepared to file a registration statement under the Securities Act.

The percentage of U.S. securityholders small enough to justify special exemptions from the securities laws for foreign issuers is necessarily arbitrary. However, we believe that ten percent is a good cutoff, since it is highly unlikely that a market in the United States or by U.S. investors could establish prices for the securities.[135] In any event, the SEC's notice

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132. Securities Act Release No. 6866, *supra* note 90, at 23,749.

133. *Id.* at 23,751–52.

134. The heart of the concept release is a request for comment on "a conceptual approach that would permit foreign bidders and offerors to make multinational tender and exchange offers in the United States on the basis of the foreign disclosure, procedural and accounting requirements, where U.S. holdings constitute a small portion of the transaction." *Id.* at 23,755.

135. Initially, the Williams Act established a 10% reporting requirement under Section 13(d)

and comment rulemaking process provides the best method of determining how to establish the percentage of securities ownership by U.S. investors in a foreign issuer that warrants full compliance with the federal securities laws prior to the making of a tender or exchange offer, a rights offer, or the inclusion of U.S. nationals in an employee stock plan.

Insofar as an appropriate exemption from the Williams Act is concerned, the SEC would be well-advised to craft an exemption under Sections 13 and 14 of the Exchange Act comparable to Rule 12g3–2. A greater challenge would be involved in crafting an exemption from registration under the Securities Act for exchange offers, rights offers and employee plans by foreign issuers. Such an exemption could be created, however, by a rule excluding such offers from the definitions of "offer to buy or sell" or "sale" for purposes of Section 5 of the Securities Act. This approach was utilized by the SEC in the past under Rule 133 for certain types of exchange offers.[136]

The same result could be accomplished by a wraparound registration under Section 5, whereby foreign disclosure documents and financial statements would be filed with the SEC rather than furnished pursuant to an exemption. However, for the same reasons discussed in connection with Recommendation One above, urging an expansion of the exemptive provisions of Rule 12g3–2, we believe that exempting foreign issuers from registration requirements is a preferable course. We also believe that an exemption for tender offers, including exchange offers, should not be limited to world class foreign issuers traded on principal foreign markets. However, it may be appropriate to so limit an exemption for rights offers and employee plans, at least when such a rule is initially promulgated, since these transactions involve raising new capital by the issuer.

3. *The SEC should develop a new "wraparound form" for foreign issuers, recognizing international GAAP standards as "authoritative" within the meaning of Rule 4–01 of Regulation S-X. The wraparound form would be designed for use as a Securities Act registration statement for multijurisdic-*

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of the Exchange Act, but with the institutionalization of the market, a five percent block was considered large enough to signal a possible control shift and the Williams Act was amended accordingly. Section 16(b) of the Exchange Act treats a 10% holder of securities as an insider. We believe that scattered ownership by U.S. investors of a foreign security is unlikely to be a significant block.

136. *See* Securities Act Release No. 5316 (Oct. 6, 1972), 37 Fed. Reg. 23,631 (1972) (rescinding Rule 133); *cf.* 17 C.F.R. § 230.135 (1992) (excluding from offers proposals to make public offers where such offer is by means of prospectus only and contains particular limited information).

tional offerings by world class foreign issuers and as an Exchange Act registration statement for foreign issuers other than world class issuers.

The adoption of Recommendations One and Two above would be significant breakthroughs in facilitating foreign issuer trading and listings in the United States. However, such new regulations would not solve the basic problem of persuading foreign issuers to enter the SEC registration and disclosure system. Over the long term, this problem would best be solved through international regulation and cooperation by regulators in the world's major capital market centers in establishing international standards. This could occur through country-by-country negotiation of multijurisdictional disclosure standards or through the promulgation of international accounting standards by the IASC, which the SEC could accept as authoritative under the Securities Act.

The federal securities laws authorize the SEC to specify a body of accounting principles governing the preparation of financial statements filed with the Commission.[137] The SEC has exercised this authority by delegating the development and improvement of accounting standards to the accounting profession, specifically, the Financial Accounting Standards Board (FASB) of the American Institute of Certified Public Accountants, subject to the SEC's authority to recognize such standards as authoritative for filing purposes.[138] The operation of this collaborative process is reflected in Rule 4–01(a) of Regulation S-X, which provides that financial statements prepared in accordance with U.S. GAAP are acceptable for filing in a registration statement:

> In all filings of foreign private issuers, . . . the financial statements may be prepared according to a comprehensive body of accounting principles other than those generally accepted in the United States if a reconciliation to [U.S. GAAP] and the provisions of Regulation S-X of the type specified in Item 18 of Form 20-F is also filed as part of the financial statements. Alternatively, the financial statements may be prepared according to [U.S. GAAP].[139]

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137. Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 4, [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,005 (Apr. 25, 1938).

138. Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,172 (Dec. 12, 1973).

139. 17 C.F.R. § 210.01-02 (1992).

As a result, the SEC's recognition of international accounting standards for foreign issuer filings would not require statutory changes, but could be accomplished through the SEC rulemaking process by amending Rule 4–01 of Regulation S-X to provide that financial statements of foreign issuers may be prepared according to international GAAP. International GAAP could then be defined on the basis of EC directives or IASC or other standards, presuming that such standards meet the SEC's approval.

Until IASC or other international standards come into effect, the SEC can continue to work toward a basic common or reciprocal disclosure and financial package for filings required by the Securities Act or the Exchange Act, working with selected foreign jurisdictions that have comparable laws and accounting regimes such as Canada, the United Kingdom and Australia. If possible, such an agreement should also be reached with the EC and Japan. This would in effect constitute a substitution for reconciliation to U.S. GAAP or international GAAP and would involve a repeal of Items 17 and 18 of Form 20-F, creating a type of transnational GAAP for the concerned jurisdictions.

Negotiating either country-by-country or for international standards is a long-term initiative. By the time such standards are set, the locus of the international securities markets could be well established offshore. Moreover, we question the wisdom of having the SEC devote its time and energy to country-by-country negotiations if these lead to non-uniform disclosure documents. Significant progress in attracting foreign issuers into the U.S. markets is needed now, and the SEC should take unilateral action to accomplish this goal.

We therefore propose a wraparound registration statement for use by foreign issuers as an alternative to Form 20-F under the Exchange Act and Form F-3 under the Securities Act. World class issuers with securities traded on principal foreign markets could use wraparound documentation for registration statements under the Securities Act, and all other foreign issuers could use wraparound documentation for registration statements under the Exchange Act. This registration statement would be comprised of the documents that have been approved for offerings or listings in the issuer's home jurisdiction, accompanied by an explanation of the manner in which the issuer's home country disclosure and accounting requirements differ from U.S. requirements.

Wraparound documentation would not involve a full reconciliation to U.S. GAAP or full compliance with SEC disclosure requirements, but would inform investors of the differences between foreign and U.S. disclosure. The disclosure would not differ greatly from the current requirements of Item 17 of Form 20-F, but the reconciliation to U.S.

GAAP would be qualitative and descriptive, rather than quantitative, unless the failure to reconcile quantitatively would make the financial statements materially misleading.[140] It would also serve as a *de facto* recognition of international accounting standards as authoritative.

We believe that an asterisk or other indication on reported transaction data, as discussed in Recommendation One, would be sufficient to inform investors that a foreign issuer does not reconcile to U.S. GAAP. If the SEC wishes to use a "carrot" as well as a "stick" approach to persuade foreign issuers to make a full reconciliation to U.S. GAAP, it could condition the use of Forms F-2 and F-3 on Item 18 requirements.

We believe that once a foreign issuer has entered the SEC disclosure system and become listed on a U.S. securities exchange, it will become less hostile to SEC requirements and less reluctant to reconcile to U.S. GAAP. At present, however, foreign issuers see Item 18 of Form 20-F and a full reconciliation to U.S. GAAP as a barrier to listing. In addition, the SEC's refusal to recognize foreign GAAP is regarded as politically offensive. With respect to some countries such as those in the United Kingdom, the difficulties are only at the margins and should not be the barrier to listings and offerings they are now. In many respects, foreign accounting is already moving in the direction of U.S. GAAP due to marketplace pressures and regulatory requirements. The SEC should continue to encourage such developments in its support of developing international standards. However, the SEC would have more influence if more foreign issuers would enter the U.S. disclosure system.

The SEC cannot accomplish this goal by sitting back and waiting for foreign issuers who do not need our capital or markets to comply with U.S. standards. A major new initiative is required, if only for purposes of improving the dialogue between the SEC and foreign securities regulators and foreign issuers. Our proposal for a wraparound registration statement would at least generate an analysis of precisely how the mandated disclosure and accounting requirements of foreign jurisdictions differ from SEC requirements.[141]

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140. A narrative disclosure rather than a numerical reconciliation to U.S. GAAP is now used in the private placement markets.

141. Our February 1991 report included recommendations for certain additional improvements in the regulation of registered foreign issuers. First, we noted a serious problem with the operation of Rule 3-19 of Regulation S-X which, among other things, required a Securities Act registration statement to include on its effective date, the balance sheet and income statement for a period ending within six months of the effective date. Karmel & Head, *supra* note 1; at 110; *see* 17 C.F.R. § 210.3-19 (1990). In 1992, the SEC amended Rule 3-19 to harmonize its requirements on

IV. CONCLUSION

The disclosure system for foreign issuers permits entry into the U.S. financial markets for those foreign issuers that have the money and the will to attempt it. However, the system is not working as well as it should and in no way encourages foreign issuers to submit to SEC regulation. At best, it puts up barriers that are impossible to overcome without the help of U.S. attorneys and accountants. The SEC has been unable to persuade most foreign issuers that reconciling to U.S. GAAP is necessary or appropriate, and foreign issuers are unlikely to reconcile their financial statements just to enter our markets.

Nevertheless, there is great demand by U.S. investors for foreign stocks, and this demand is likely to continue. That the SEC is protecting investors against their will and self-interest is demonstrated by the pressure institutions have put on the SEC to exempt them from such protections. The end result is Regulation S and Rule 144A, which provide no relief to those other than institutional investors and serve to encourage an offshore market in foreign equities rather than a market

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the age of financial statements to the requirements of the home jurisdiction. Securities Act Release No. 6895 (June 5, 1991), 56 Fed. Reg. 27,988 (1991).

Another troublesome problem, particularly for British issuers, is the current law on gun-jumping. *See* Karmel & Head, *supra* note 1, at 111–12. A U.S. issuer in registration must exercise caution to avoid making public statements that could be construed as an attempt to condition the market for the proposed offering. Publicity about the company, its business, or its products intended to arouse public interest in the issuer or its securities could be viewed by the SEC or the courts as an "offer to sell" in violation of Section 5(c) of the Securities Act. In the United Kingdom, no such restrictions are placed on issuers. Although the SEC has informally closed its eyes to the type of publicity customary for offerings in the United Kingdom and even advised that U.S. reporters may attend press briefings by British companies in advance of an offering, British companies and their advisors are uncomfortable with this approach and would appreciate more formal interpretive advice from the SEC. Such advice has now been given concerning offshore offerings pursuant to Regulation S, but comparable interpretive rulemaking is needed for SEC-registered multijurisdictional offerings. *Id.*

Finally, one of the most difficult aspects of SEC regulation for foreign issuers to accept is that changes in disclosure and financial statement requirements applicable to U.S. issuers are automatically applicable to foreign issuers by reason of the operation of Item 18 of Form 20-F without sufficient input and analysis. The type of exemptions and wraparound filings envisioned by the recommendations in this report would alleviate this problem because new or changed disclosure or accounting rules would have to be made explicitly applicable to foreign issuer disclosure documents in a notice and comment process separate from the process for U.S. issuers. *Id.* at 112. In the interim, it would be helpful if the SEC would undertake to consider, when a new FASB standard is adopted, whether the standard must be met under Item 17. While this would not solve Item 18 problems, it would at least focus the SEC staff, foreign issuers and their advisers on any compliance or other problems presented by new standards.

within the SEC's jurisdiction. Transaction costs to non-QIB investors who purchase foreign securities are higher than they would be if such securities were available in the United States. Further, the SEC has permitted retail investors to purchase single country mutual funds that are not diversified and that may contain securities which would never be considered world class securities meeting NYSE listing requirements. Reform of foreign issuer listing regulations is sorely needed.