Securities Industry Association

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Mr. Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Proposed Revisions of Rules 144 and 145 and Regulation S under the Securities Act of 1933 (File Nos. S7-07-97 and S7-8-97)

Dear Mr. Katz:

The Capital Markets Committee, the Federal Regulation Committee and the OTC Derivative Products Committee (the "Committees") of the Securities Industry Association (the "SIA ")[1] are writing in response to the releases issued by the Securities and Exchange Commission (the "Commission" or "SEC") on February 20, 1997 regarding proposed revisions to Rules 144 and 145 (the "Rule 144/145 Release")[2] and Regulation S (the " Regulation S Release")[3] under the Securities Act of 1933 (the "Securities Act "). The Committees support the Commission's efforts to revise, streamline and simplify Rules 144 and 145 and to amend Regulation S, and welcome the opportunity to provide their comments and suggestions to the Commission and its staff in connection with this important project.

I. THE RULE 144/145 RELEASE -- GENERAL MATTERS

A. Background

Rule 144 is a nonexclusive safe harbor that permits (i) persons that control, are controlled by, or are under common control with, an issuer ("affiliates"), and (ii) persons that have obtained securities directly or indirectly from an issuer (or an affiliate thereof) in a transaction or chain of transactions not involving a public offering, to resell such securities (referred to as "restricted securities" or, in the case of affiliates that acquired securities in the public market, "control securities") publicly without being deemed "underwriters" with respect to such resale.

In the Rule 144/145 Release, the Commission requests comment with respect to its proposals to (i) revise and simplify the Preliminary Note to Rule 144; (ii) add a "bright-line" test to the Rule 144 definition of "affiliate" to make it easier to determine who is an affiliate for purposes of the Rule; (iii) eliminate the Rule 144 manner of sale requirements; (iv) reduce Form 144 filings by increasing the Form 144 filing thresholds; (v) clarify, consistent with prior staff interpretive positions, the determination of the holding period in connection with securities acquired in certain exchanges with the issuer and in holding company formations; (vi) expressly include securities issued pursuant to Section 4(6) under the Securities Act within the Rule 144 definition of "restricted securities"; (vii) further shorten the holding period requirements of Rule 144; and (viii) modify the volume limitation tests contained in Rule 144. The Rule 144/145 Release also requests comment with respect to the Commission's proposal to eliminate the "presumptive underwriter" provisions of Rule 145.[4]

The Committees' responses to the Commission's requests for comment are set forth below.

B. Proposals Intended to Streamline and Simplify Rule 144

1. Revisions to the Preliminary Note to Rule 144. In the Rule 144/145 Release, the Commission proposes to revise and restate the Preliminary Note to Rule 144 (the "Preliminary Note") in an effort to clarify the intent of the Rule and to stress that the Rule is a nonexclusive resale safe harbor. The Commission requests comment as to whether additional matters should be addressed in the Preliminary Note or removed therefrom.

The Committees support the Commission's efforts to revise the Preliminary Note and to clarify the intent of the Rule. In particular, the Committees believe that it is important for the Commission to make clear that Rule 144 is not the exclusive means by which affiliates and holders of restricted stock may sell their securities publicly without being deemed underwriters. Although this statement is currently set forth in paragraph (j) of the Rule, the Committees agree that it should more properly be set forth in the Preliminary Note.

2. Definition of Affiliate. Rule 144 defines an affiliate of an issuer as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." In order to provide some guidance in determining who would or would not be an "affiliate" for purposes of the Rule, the Commission proposes to use Section 16 (" Section 16") under the Securities Exchange Act of 1934 (the "Exchange Act") as a frame of reference and expressly exclude from the Rule 144 definition of "affiliate" those persons who are not officers, directors or 10% beneficial stockholders. The determination of whether a control relationship exists in the case of other persons (and hence whether such other persons would be deemed to be affiliates under the Rule) would continue to depend on an analysis of the particular facts and circumstances involved. The Commission requests comment as to whether this Section 16-based approach to determining affiliate status is appropriate or whether an alternative test should be used. The Commission also requests comment as to whether there should be a presumption that persons that are "statutory insiders" under Section 16 are affiliates and whether such presumption should be rebuttable.

The Committees support the creation of a "bright-line" safe harbor that would eliminate persons who are clearly not in a position of control with respect to an issuer from the definition of "affiliate". The Committees particularly appreciate the usefulness of a bright-line safe harbor under Rule 144 in terms of convenience and simplicity. However, the Committees believe that it is critical that if a person falls outside the proposed safe harbor, whether that person would be deemed an affiliate should be determined based on all of the facts and circumstances, and that the Commission make clear and explicit in the Rule (as it did, for example, in the case of Rule 10b-18 under the Exchange Act), that no presumption arises that such a person is an affiliate for purposes of Rule 144.

In considering which bright-line test should be adopted, however, the Committees believe that the premise underlying Section 16 involves presumed access to information by statutorily defined classes of insiders, and that this premise is substantially distinguishable from the concepts of control that appear in both Rule 144 and Section 2(11) of the Securities Act ("Section 2(11)").**5** From the legislative history, it seems that the principal reason for equating "control persons" with issuers for purposes of Section 2(11) is that such persons are presumably able to compel the issuer to initiate the registration process. **6** However, the theories and policy goals underlying Section 16, on the one hand, and Section 2(11) and Rule 144, on the other, are quite different. While it is reasonable to conclude that those persons who are deemed generally not to have access to corporate inside information are extremely unlikely to be in a position to control financing activities by, or to otherwise direct the management or policies of, an issuer, the Committees believe that the converse is simply not true. In particular, in the context of current markets and governance practices, a holder of between 10 and 20% of the voting power of an issuer that is not also a member of, or does not control the election of a member of, the issuer's board of directors can, in the Committees' view, be presumed not to "control" the issuer.

The Committees therefore believe that, while definitions imported from Section 16 of statutory insiders, including officers (within the meaning of Section 16), directors and 10% beneficial owners, might be useful as a matter of convenience and simplicity to create a safe harbor under Rule 144, the difference in statutory purpose militates against importing wholesale the concepts of Section 16 into the analysis of who is an affiliate under Rule 144. For example, a person whose sole interest in an issuer consists of 10% of a class of Section 12-registered preferred securities would be required to file reports with the Commission under Section 16, but certainly should not be viewed as exerting any degree of control over the issuer such that it would (or should) be viewed as an "affiliate" of the issuer for purposes of Rule 144 or the registration requirements of Section 5 of the Securities Act ("Section 5").

In the Committees' view, these facts and the policy goals underlying Rule 144 support the creation of a nonexclusive safe harbor based on the definition of affiliate proposed by the Advisory Committee on the Capital Formation and Regulatory Processes (the "Advisory Committee"), which was established by the Commission in February 1995 to examine, among other things, the current regulatory framework for securities offerings. In the context of its "company registration" proposal, the Advisory Committee recommended the adoption of a definition of affiliate that would include only the following persons: (i) the company's Chief Executive Officer; (ii) the company's inside directors; (iii) holders of at least 20% of company's voting power; and (iv) holders of at least 10% of the company's voting power with at least one board representative.**7** The Committees urge the Commission to adopt a safe harbor definition of "affiliate" that reflects the standards proposed by the Advisory Committee. In particular, the Committees urge that any safe harbor exclude from the definition of "affiliate" a holder of less than 20% of the voting power of an issuer unless such holder is a member of, or has the right to elect a member of, the issuer's board of directors. The Committees also agree that a holder of 20% or more of the voting power of an issuer, with or without board representation, should not be allowed to rely on the safe harbor. As noted above, however, the Committees believe that it is important for the Commission to make clear that no presumption of affiliate status would attach to persons falling outside of the definitional safe harbor and such persons could, in seeking to rely on Rule 144, continue to determine affiliate status based on an analysis of all the relevant facts and circumstances.

Finally, the Committees believe that the Commission should adopt a parallel safe harbor from the definition of "affiliate" as such term is used for purposes of Section 2(11). This would assure identical treatment under Section 2(11) and Rule 144.

3.Manner of Sale. Rule 144(f) imposes, except under certain circumstances, "manner of sale" restrictions with respect to the offer and sale of securities sold in reliance on the Rule. Among other things, the Rule requires that such securities be sold in "brokers' transactions" within the meaning of Section 4(4) of the Securities Act (as interpreted for purposes of the Rule by paragraph (g) thereunder) or in transactions directly with a "market maker" as such term is defined in Section 3(a)(38) of the Exchange Act. Such restrictions were intended to "assure that special selling efforts and compensation arrangements usually associated with a distribution are not present in a Rule 144 sale." The Commission is now proposing that such manner of sale restrictions be eliminated. The Commission, however, requests comment as to whether the removal of such restrictions is appropriate or whether, instead of removing them altogether, other modifications should be made to the manner of sale requirements to achieve other appropriate regulatory objectives.

The Committees strongly believe that the interposition of broker-dealers in Rule 144 transactions serves a useful and important "gatekeeper" function by ensuring that the elements of the Rule are met and that the Commission should, in order to protect against unregistered distributions, preserve the role of broker-dealers under Rule 144. The Committees believe that broker-dealers are uniquely situated to fulfill this role and do not believe that issuers or transfer agents have the desire or resources to take on such responsibility. Even assuming that they would be willing to take on such responsibility, issuers and transfer agents too often become involved (and thus can have a serious "policing" role) only "after-the fact". Moreover, should the role of the broker-dealer be eliminated, it is unlikely that issuers or transfer agents would be contacted any earlier in the process, particularly since it has traditionally been, more often than not, the broker-dealer that has brought the issuer and transfer agent into the process when it is first contacted by a customer to evaluate a proposed Rule 144 sale. Relying on issuers and transfer agents to fulfill the broker-dealers' traditional gatekeeper role is thus an invitation to have an increasing number of trades executed without adequate, pre-sale consideration of whether the requirements of Rule 144 are being complied with. Indeed, some transfer agents have already indicated to members of the Committees that, under their current staffing levels, they would not have adequate resources to police compliance with Rule 144 on their own, and the Committees frankly believe that it is unlikely that additional resources would be made available to transfer agents to carry out such function.

In addition, the Committees believe that sales under Rule 144 should continue to be made into the public market rather than in private transactions. The Committees thus strongly recommend that the Rule continue to require that sellers sell their restricted and control securities through a broker-dealer in a transaction exempt from registration pursuant to Section 4(3) or 4(4) of the Securities Act. **8**

The Committees do, however, agree with the Commission that, in light of the holding period and volume limitations of Rule 144, certain of the manner of sale requirements are unnecessary and serve to constrain types of selling methods and transactions that are non-distributive in nature and that should not be restricted. They also limit the ability of the broker-dealer to fulfill its responsibility to obtain "best execution" for its customer.**9** The Committees therefore support the removal of the provisions that prohibit the broker-dealer from soliciting purchasers in Rule 144 transactions and that require that the broker-dealer receive no more than the "usual and customary broker's commission". Moreover, the Committees believe that Rule 144 should be amended to clarify that a broker-dealer selling securities as principal under Rule 144 (where current Rule 144(k) is not available) may sell such securities on its own behalf without having to effect such transactions through another broker-dealer. **10** These steps would achieve the Commission's objective to facilitate additional methods of selling and solicitation as set forth in the Rule 144/145 Release.

4.Form 144 Filing Requirement. Rule 144(h) currently requires a person proposing to sell under the Rule an amount of securities that, during a three month period, exceeds 500 shares or other units or that has an aggregate sales price in excess of $10,000 to file with the Commission a notice thereof on Form 144 and to transmit a copy of such notice to the principal securities exchange (if any) on which the securities are then admitted to trading. The Commission proposes to amend Rule 144(h) by increasing the filing thresholds to 1,000 shares or $40,000, but requests comment as to whether such new thresholds are appropriate and whether different thresholds should be adopted with respect to small business issuers.

The Committees strongly support the proposed increase in the Form 144 filing thresholds and believe that the new amounts more accurately reflect current average levels of price per share and number of authorized shares outstanding. Indeed, the Committees had suggested the 1,000 shares/$40,000 thresholds in their comment letter to the Commission dated September 19, 1995 (the "1995 Comment Letter"), which was submitted in response to Commission's June 27, 1995 release regarding proposed changes to Rule 144.**11**

The Committees also concur in the Commission's view that the establishment of separate filing thresholds for small business issuers is unnecessary and would result in needless complication of the Form 144 filing requirements.

In addition to raising the filing thresholds, however, the Committees also recommend that the Form 144 filing requirement be set forth as a separate obligation of the seller rather than as an element of the Rule 144 safe harbor. As set forth in the Preliminary Note, the acknowledged purpose of the safe harbor is to provide a framework for determining that a particular transaction has not resulted in a distribution of the subject securities and that, therefore, the seller should not be viewed as an underwriter with respect thereto and the purchaser should be deemed to have received unrestricted securities. The Form 144 filing requirement serves a useful function in that it alerts the Commission and the public that a sale of restricted or control securities has taken place (and thus alerts investors that such securities have entered the "public" market and allows monitoring of such sales) but is not determinative of whether a distribution has occurred. Accordingly, the Committees do not believe that reliance on the safe harbor should depend on whether or not the Form has been filed by the seller.[12]

The Committees also believe that some modification and clarification with respect to when the Form should be transmitted for filing is required. Given the practical realities involved in effecting transactions under Rule 144, the Committees believe that the Form should be required to be transmitted for filing on or prior to the trade date for the subject securities rather than "concurrently with either the sale of [the] securities . . . or the placing with a broker of an order to sell [the] securities" as is currently required by the Rule. Earlier filing of the Form under the existing provisions of Rule 144 can require that it be filed before a sale is effected, and even before a decision to sell on particular terms has been made. This can unnecessarily disadvantage a seller or the executing broker-dealer, and can even send a misleading signal to the market. The Committees believe that the proper objectives of the filing of the Form as described above are fulfilled by requiring its filing on or prior to trade date.

The Committees would also ask that the Commission make a further technical improvement to the current requirements of Rule 144 relating to Form 144 by adding a provision clarifying an informal staff position that the Form may be signed and filed by power of attorney. [13] Signature by an authorized attorney-in-fact would facilitate sales under Rule 144 in certain cases where the seller may not be available to execute the Form on a timely basis. While the Committees understand that certain aspects of the Form relate to information regarding the seller (in particular, the representation that the seller "does not know of any material adverse information in regard to the current and prospective operations of the issuer . . . which has not been publicly disclosed"), this should not preclude use of an attorney-in-fact. Commission policy thus should not militate against the additional convenience that the use of powers of attorney for Form 144 would allow.

5.Codification of Certain Prior Staff Interpretive Positions. Rule 144(d)(3)(ii) provides that securities acquired from an issuer upon the conversion of securities of the same issuer will be deemed to have been acquired when the securities surrendered for conversion were originally acquired (*i.e.,* the holding period with respect to the surrendered securities may be "tacked" on to the holding period for the new securities). The Commission is proposing to amend this provision by codifying prior staff interpretive positions that clarify that this tacking provision is available (i) whether or not the securities are convertible by their terms and (ii) in situations in which new securities of the same issuer are acquired in connection with an exchange rather than upon conversion.

Proposed changes to Rule 144 would also clarify, consistent with prior staff interpretive positions, that (so long as certain specified conditions are met) tacking of the holding periods is permitted in connection with transactions effected solely for the purpose of forming a holding company.

The Committees support the Commission's proposals to codify the foregoing staff interpretive positions and believe that by setting forth such positions and similar additional positions within the Rule itself, market participants will be able to more easily understand the Rule and make more efficient use of their own and the Commission staff's time and resources. Accordingly, the Committees propose that the following additional prior staff interpretive positions also be incorporated in the Rule:

(i) *Horizontal Aggregation*. The Commission staff have previously expressed the view that sales made by transferees of restricted securities would not need to be aggregated together with sales by other transferees in the absence of coordinated action by such transferees. **14** The Committees believe that incorporation of this staff position will assist market participants in applying the volume limitations of the Rule.

(ii) *Cashless Exercises*. The Commission staff have previously taken the position that the holding period of securities underlying warrants or options may be "tacked" on to the holding period of the exercised securities, so long as the underlying securities are received in connection with a "cashless exercise" of the original securities (*i.e.,* receipt of the underlying securities involves no consideration other than the surrender of the original securities). **15** The Committees believe that incorporation of this staff position will clarify the instances in which tacking is permissible under the Rule and will thereby assist market participants in applying the Rule's holding period requirements.

The Committees acknowledge that the Commission's position with respect to "cashless exercises" is dependent in part on the fact that the issuer of the warrants or options and the issuer of the underlying securities is the same entity. The Committees would advocate, however, that the Commission expand their prior no action position to cover situations in which an affiliate of an issuer writes a warrant or option on the issuer's securities. The Committees believe that the analysis behind the Commission' position with respect to cashless exercises (which is based on there being no new investment decision and no consideration other than the surrender of the original securities) is equally applicable where an affiliate, rather than the issuer, is the writer of the warrant or option. Accordingly, the Committees believe, especially in light of the approach taken with respect to affiliates of issuers in Securities Act 2(11) (*i.e.,* that, for purposes of the definition of "underwriter", the term "issuer" includes affiliates of the issuer), that equal treatment is warranted in connection with cashless exercises of warrants or options written by an affiliate of the issuer of the underlying security.

(iii) *Pledgees*. Rule 144(d)(3)(iv) states that securities that have been *bonafide* pledged (with recourse) by an affiliate of an issuer will, when sold by the pledgee following a default be deemed to have been acquired by the pledgee (or its purchaser in a foreclosure sale) when they were acquired by the affiliate (*i.e.,* the pledgee or such purchaser can "tack" the affiliate's holding period to its own). In addition, the Commission staff have, on numerous occasions, confirmed that a pledgee of restricted or control securities may sell such securities in accordance with Rule 144(k) (and thus need not comply with the volume, manner of sale, information or notice requirements of Rule 144), so long as the holding period under Rule 144(k) has elapsed (taking into account the tacking concept referenced above) and the pledgee is not at the time of the sale (nor was it within the preceding three months) an affiliate of the issuer. **16** The Committees believe that the ability of a pledgee of restricted or control securities to sell, on its own behalf, such securities upon a default by the pledgor (where the pledge is *bona fide* and with recourse to the pledgor) pursuant to Rule 144(k) should be incorporated into the Rule.**17**

6. Definition of "Restricted Securities". Section 4(6) of the Securities Act exempts from the registration requirements of Section 5 offers and sales of securities made by issuers solely to accredited investors, so long as the aggregate amount thereof does not exceed $5 million. The Commission proposes to amend the definition of the term "restricted securities" under Rule 144 to clarify that securities acquired from an issuer pursuant to the Section 4(6) exemption are deemed to be "restricted securities" for purposes of the Rule.

The Committees agree that securities received in connection with a Section 4(6) transaction should be treated the same as securities received in other non-public offerings, and hence that such securities should be expressly included within the categories of securities deemed "restricted securities" for purposes of the Rule.

7.Further Shortening of Holding Period Requirements. Since its adoption by the Commission in 1972, Rule 144 imposed two holding period requirements on persons seeking to rely on the Rule to effect resales: (1) a person holding restricted securities may, without Securities Act registration, publicly resell such securities, subject to certain volume and manner of sale limitations and other requirements ("resale limitations"), after two years, and (2) a person holding restricted securities that is not an affiliate (and was not an affiliate within the preceding three months) may, without Securities Act registration, publicly resell such securities -- free of resale limitations -- after three years. Concurrently with the issuance of the Rule 144/145 Release, however, the Commission adopted amendments to Rule 144 that, effective April 29, 1997, shortened the foregoing holding period requirements to one year and two years, respectively (the "revised holding periods").[18]

In the Rule 144/145 Release, the Commission requests comment as to whether the revised holding periods should be shortened even further -- perhaps, among various other suggested scenarios, to six months and 18 months, respectively.

The Committees support the Commission's action to shorten the holding period requirements of Rule 144. Moreover, the Committees concur with the Commission's view that the revised holding periods will enhance the utility of the Rule 144 safe harbor and reduce the costs of raising capital without compromising the interests of investors. Nonetheless, and although shorter holding periods might also suffice to demonstrate that the purchaser is not participating in a distribution,[19] the Committees believe that the revised holding periods should be given the opportunity to be tested in practice before advocating that they be further reduced.

8.Volume Limitation Tests. The Commission also requests comment as to whether to amend Rule 144(e) to modify the method of determining the maximum amount of securities that may be sold by affiliates or by non-affiliates after satisfying the current one year holding period requirement. Presently, Rule 144(e) provides three alternative methods for determining the volume limitation imposed by the Rule: the first method is based on the amount of securities outstanding; the second and third methods are based on the average weekly trading volume of the securities.[20] The Commission is proposing to retain the first method and eliminate the two that are based on trading volume.

The Committees strongly disagree with the Commission's proposal to eliminate the two volume limitation tests based on average weekly trading volume. Although the Committees agree that the Rule would be simpler to apply if there was a single test to determine the maximum amount of securities that may be sold after the one year holding period, the Committees believe that it would be inappropriate to sacrifice the Rule's utility for the sake of simplicity.[21] Trading volume can be an important measure of liquidity that would justify a higher permissible volume limitation under Rule 144 in the case of certain actively traded issuers. Average weekly trading volume is therefore an additional appropriate measure of the impact that Rule 144 sales will have on the market for the subject securities.

C. Proposed Changes to Rule 145

Rule 145 applies to offers and sales of securities received in connection with certain mergers, acquisitions and similar transactions. Specifically, Rule 145(c) provides that a person who acquires registered securities in connection with a public merger or other acquisition or similar transaction registered with the Commission and requiring a shareholder vote (" public acquisition transactions") will be deemed to be an "underwriter" with respect to the subsequent public resale of such securities if such person was an affiliate of either the acquiror or acquiree in such transaction. Such "presumptive underwriter" status may be rebutted, however, if the subsequent resale is effected in accordance with the requirements of Rule 145(d), which applies to the resale the volume and manner of sale and certain other requirements of Rule 144. Believing that Rule 144 (which would address, and provide a safe harbor with respect to, resales by affiliates of the acquiror) provides a sufficient framework to determine underwriter status, the Commission is proposing to eliminate Rule 145's presumptive underwriter approach.**22** If such proposal were adopted, the Securities Act-related resale restrictions on securities received in a public acquisition transaction by an affiliate of the acquiree that is not also an affiliate of the acquiror would generally be eliminated. The Commission, however, requests comment as to whether such action is appropriate or whether Rule 145 should continue to provide some form of guidance with respect to underwriter status and/or a resale safe harbor in addition to the one provided by Rule 144 in connection with public acquisition transactions.

The Committees concur in the Commission's view that the presumptive underwriter provisions of Rule 145 should be eliminated and that the provisions of Rule 144 provide a sufficient safe harbor for resales of securities by affiliates of issuers. The Committees also agree that affiliates of the acquiree that are not also affiliates of the acquiror should not be viewed as "underwriters" with respect to the resale of securities received in connection with public acquisition transactions and that such persons should be able to rely on the exemptions provided by Sections 4(1) or 4(3) in connection with their resales.

II. THE RULE 144/145 RELEASE -- HEDGING DISCUSSION

A. Background.

In the 1995 Rule 144 Release, the Commission requested comment on the appropriate treatment under Rule 144 of equity swaps, forward contracts, derivatives and other financial products that effectively shift various incidents of ownership of securities to another party without affecting the legal title to the securities underlying such products (collectively, "Hedging Transactions"). The 1995 Rule 144 Release also stated that the Commission was reconsidering reintroducing into Rule 144 the holding period tolling provision that was deleted by amendment in 1990 for periods during which the holder has entered into a Hedging Transaction or by adding a provision to Rule 144 expressly prohibiting risk-shifting transactions altogether during the applicable holding period.

Hedging Transactions are generally entered into by investors to reduce or eliminate the risk that the market value of an investment will decline during a specified period of time. By decreasing volatility, increasing liquidity, and thus offering investors a way to manage their overall level of risk, Hedging Transactions greatly facilitate the capital raising process. In particular, the ability to engage in Hedging Transactions has proved useful in the capital raising efforts of many small companies and in facilitating the realization by entrepreneurs of the fruits of their activities following dispositions of their businesses to public companies.

In the Rule 144/145 Release, the Commission again requests comment as to the proper regulatory approach with respect to Hedging Transactions involving restricted and control securities. The Rule 144/145 Release notes the Commission's concern that "in economic reality, a distribution [may occur] when a company sells unregistered restricted stock to an investor who, in turn, hedges the market risk through an equity swap with an investment bank, which then sells an equal number of securities into the market."

Accordingly, the Commission is requesting, among other things, comment as to whether to (i) make the Rule 144 safe harbor unavailable to persons that engage in Hedging Transactions during the holding period, (ii) adopt a rule defining the term "sale" for purposes of Section 5 to include certain specified types of Hedging Transactions, (iii) adopt a shorter holding period (*e.g.,* three or six months) under Rule 144 during which certain Hedging Transactions would be prohibited, or (iv) reintroduce the holding period tolling concept deleted in 1990.

The Committees' responses to the Commission's requests for comment are set forth below.

B. General Principles Underlying Rule 144.

Rule 144 provides a nonexclusive safe harbor to sellers of restricted securities and to sellers of control securities. In either case, if the elements of the safe harbor are satisfied, the seller will be deemed not to be an "underwriter" of the securities to be sold and can therefore rely on the exemption from registration provided by Section 4(1) (or, if such seller is a dealer, Section 4(3)) of the Securities Act in connection with the sale.

Restricted securities, in general, are securities that have been acquired directly or indirectly from an issuer or an affiliate of the issuer in a private transaction. Thus, in the case of restricted securities held by non-affiliates, the elements of the Rule 144 safe harbor (in particular, the holding period requirement) are designed to ensure that the seller acquired such securities for investment purposes and not with a view to an unregistered public distribution.

Control securities are securities that were acquired in a publicly registered transaction, but are subject to restrictions on resale because they are held by an affiliate of the issuer. Because of the affiliate's relationship with the issuer, the provisions of Rule 144 are, in the case of control securities, intended to ensure that sales by an affiliate are of sufficiently low magnitude (and that there is adequate public information) such that the sales will not have an impact on the market for the issuer's securities. In the case of restricted securities held by affiliates, the provisions of Rule 144 are intended to fulfill both these policies and those described in the preceding paragraph.

C. Use of Equity Derivatives and Other Hedging Transactions.

The use of various strategies involving derivatives to hedge or shift economic risk in connection with equity securities is growing, but is also relatively recent and still evolving. New strategies are developed on a frequent basis and some prove useful while others are discarded for any of a number of business or regulatory reasons. The Committees understand that the Commission's interest in exploring the need for regulation of the use of Hedging Transactions in respect of positions in restricted or control securities arises not so much from a perception that abuses are occurring in the area as from a concern that the use of such Hedging Transactions might lead to indirect unregistered distributions of such securities. Finally, the Committees believe that most market participants involved in the design and use of Hedging Transactions have acted responsibly so that such transactions do not result in unregistered distributions of restricted or control securities.

The Committees recognize the Commission's concern regarding the use of Hedging Transactions by holders of restricted or control securities. However, in light of the benefits provided by Hedging Transactions, the evolving nature of derivatives products and the derivatives market, the lack of perceived abuses and the industry's activities to date in adopting procedures designed to avoid facilitation of unregistered distributions, the Committees believe that the Commission should not, at least at this time, attempt to establish a comprehensive regulatory framework for Hedging Transactions. Rather, the Committees believe that, if the Commission elects to address the regulatory issues in this area, it should do so by providing general interpretative guidance and establishing certain safe harbors. Any such safe harbors should be clearly consistent with the principles that the Commission believes should be followed. The Committees believe that transactions falling outside the safe harbors should continue to be evaluated by market participants and their legal advisers on a case-by-case basis.

The Committees believe that the Commission's interpretative guidance with respect to Hedging Transactions should follow from these general principles:

-- Hedging Transactions cannot properly be equated with sales of the underlying securities. Hedging Transactions do not eliminate all of the risks or incidents of ownership of the underlying securities. The various motivations of holders that enter into Hedging Transactions, which include adjusting the risk profile resulting from particular securities positions, monetizing gains, and perhaps obtaining tax-advantaged treatment, while maintaining the other risks and indicia of ownership, or functionally purchasing insurance against market declines while maintaining ownership, are legitimate and can be different from those of sellers. Hedging Transactions that are cash-settled do not result in the underlying securities being sold into the public market.

-- Certain of the concepts as to which the Commission seeks comment, such as possibly adopting a definition of "sale" that captures Hedging Transactions, would require the Commission to return to the concept of fungibility. As discussed below, the Committees strongly believe that the concept of fungibility was properly abandoned and should not be revitalized.

-- Many Hedging Transactions likewise do not have indicia of an indirect distribution of the underlying securities. Nonetheless, the Committees understand that the Commission questions whether there may be certain Hedging Transactions entered into by holders of restricted or control securities that possess indicia of an indirect distribution by these holders such that the resulting sales into the market of identical securities by the counterparties to such Hedging Transactions (generally derivatives dealers or their securities dealer affiliates) could raise registration concerns under the Securities Act.

-- The Committees believe that a Hedging Transaction should<u>not</u> be viewed as part of an indirect distribution unless<u>both</u> of the following two characteristics are present:

- First, the Hedging Transaction should have the economic characteristics of a sale by the holder of the restricted or control securities. In particular, to resemble a sale, the securities underlying the Hedging Transaction would have to be of the "same class" as the restricted or control securities held and the Hedging Transaction would have to eliminate substantially all economic risk of ownership of such securities.
- Second, the Hedging Transaction analyzed in its entirety should result in a sale of the restricted or control securities in question. If, on the completion of the transaction, there has been no net disposition by the holder and the dealer counterparty, the intervening transactions should not be interpreted as a sale

-- While it is the characteristics of the Hedging Transaction that must be analyzed to determine whether a distribution by the holder of restricted or control securities may be taking place, it is only the immediately resulting or inexorably linked sales into the market by the dealer counterparty that should be the focus of regulatory scrutiny as to whether registration is appropriate.

-- If the Commission were to require Securities Act registration to be undertaken in connection with sales by a dealer counterparty to a Hedging Transaction with a holder of restricted or control securities, such registration should only be required for the sales by the dealer that are the immediate or inexorable result of the dealer's entering into such Hedging Transaction (and thus can be attributed more directly to the transaction with the holder), but not for sales by the dealer that are the result of subsequent market movements (which sales might not have occurred but for the entry into the Hedging Transaction, but are more clearly characterized as being for the dealer's own account and are more clearly independent of any activity or interest of the holder).

D. <u>Fungibility Concept</u>.

In the 1995 Rule 144 Release and again in the Rule 144/145 Release, the Commission has expressed its concern that the use of certain Hedging Transactions by holders of restricted or control securities may sufficiently shift the economic risks of owning such securities to the counterparty to such Hedging Transaction such that the entry into such Hedging Transaction should be viewed as the economic sale by the holder of its restricted or control securities. Adoption of this view without taking into account the other concepts discussed above would effectively reintroduce the "fungibility" concept that was abandoned by the Commission when it adopted Rule 144 in 1972.**23** Under the concept of fungibility, the holding period under Rule 144 would be measured from the time of the most recent acquisition of securities of the same class as the restricted securities. The concept is based on the premise that one share is replaceable (or "fungible") with another share because each share represents the same characteristics and economic interest in the issuer. As noted in the 1995 Comment Letter, however, restricted securities and unrestricted securities are not fungible with one another because of their different risk, transferability and liquidity attributes. Such differences typically result in different trading markets and price differentials between restricted and unrestricted securities.

One of the goals of the Commission in proposing revisions to Rule 144 is to reduce the costs of raising capital and to increase market efficiency. Inclusion of a fungibility concept in Rule 144 can only have the opposite effect. Suppose that a person acquires 1,000 shares of an issuer's class of equity securities in a publicly registered transaction and six months thereafter acquires 1,000 shares of the same security in a private placement. The fungibility doctrine would require such person to wait a full year after acquiring the restricted securities before being able to publicly resell any of such securities (including those that were acquired in the publicly registered transaction). In another example of the flawed nature of the fungibility doctrine in the context of Rule 144 consider the following: today, a person can engage in a short sale transaction without at the time owning any shares of the security being sold; if such person held restricted securities, however, introduction of the fungibility concept would restrict such person's ability to engage in the same short sale. At its extreme, the fungibility doctrine could significantly impair market efficiency and the ability to raise capital for business entities (in particular, small entrepreneurial companies) through private placements, private merger transactions, employee stock option plans and other activities conducted in the private markets.

E. The Committees' Proposed Hedging Safe Harbor.

For the reasons discussed above, the Committees strongly believe that it would be a serious mistake to include the concept of fungibility in Rule 144. The Committees also believe that the use of Hedging Transactions should not preclude reliance on the Rule 144 safe harbor. Nonetheless, also as discussed above, the Committees recognize that the Commission has a legitimate interest in ensuring that the Rule 144 safe harbor is not abused and is not inadvertently used as an indirect method of engaging in unregistered public distributions. The Committees propose that the Commission adopt two new nonexclusive safe harbors with respect to Hedging Transactions -- one for affiliates (the "Affiliate Safe Harbor") and one for non-affiliates (the "Non-Affiliate Safe Harbor" and, together with the Affiliate Safe Harbor, the "Hedging Safe Harbor"). The differences between the Affiliate Safe Harbor and the Non-Affiliate Safe Harbor acknowledge the different purposes underlying Rule 144 in connection with sales of restricted securities and control securities. These safe harbors would apply to transactions that clearly would be permissible under the general principles outlined above.

The Committees' Hedging Safe Harbor proposal is as follows:[24]

(a) Non-affiliates Holding Restricted Securities. A non-affiliate holding restricted securities may enter into cash-settled Hedging Transactions with respect to the restricted securities or securities of the same class [25] (i) after a period of three months has elapsed from the time the restricted securities were issued or acquired from an issuer or an issuer affiliate, or (ii) at any time after the restricted securities were issued or acquired from an issuer or an issuer affiliate, provided that such non-affiliate does not dispose of substantially all of its economic interest in the restricted securities. A holder would be deemed not to have disposed of "substantially all of its economic interest" if it retained exposure to at least a 10% decline in the price of the restricted security held ("10% price exposure"). To rely on either clause (i) or clause (ii) of the

Non-Affiliate Safe Harbor, the restricted securities held by the non-affiliate could not be used to cover any short sales or other transactions engaged in by the non-affiliate or its counterparty as a result of any such Hedging Transaction.

(b) Affiliates Holding Restricted or Control Securities. An affiliate holding restricted or control securities may enter into cash-settled Hedging Transactions with respect to the restricted or control securities or securities of the same class, provided that (1) the amount of securities underlying the Hedging Transactions entered into in any three-month period by the affiliate (and others with whom it acts in concert) does not exceed the volume limitations set forth in Rule 144(e), and (2) in the event that the Hedging Transactions relate to restricted securities, either (i) a period of three months has elapsed from the time the securities were issued or acquired from an issuer or an issuer affiliate, or (ii) the affiliate does not dispose of substantially all of its economic interest in the securities. As in the case of the Non-Affiliate Safe Harbor, an affiliate would be deemed not to have disposed of substantially all of its economic interest if it retained 10% price exposure. Finally, in order to rely on the Affiliate Safe Harbor, the restricted or control securities held by the affiliate cannot be used to cover any short sales or other transactions engaged in by the affiliate or its counterparty as a result of any such Hedging Transaction.**26**

A non-affiliate holding restricted securities or an affiliate holding restricted or control securities is (and after adoption of the Hedging Safe Harbors as proposed would continue to be) permitted to sell such securities, including at the termination of a Hedging Transaction, pursuant to an effective registration statement, the safe harbor provisions of Rule 144 (including, in the case of non-affiliates, paragraph (k) thereof), or another exemption from Securities Act registration.

While a prohibition against use of the restricted securities (or, in the case of affiliates, control securities) to close-out or cover short sales or other transactions by the holder of such securities or its counterparty has been included as a condition of the Hedging Safe Harbor, such restriction should not be applicable in the case where the hedge-related sales by the holder or its counterparty satisfy all of the then-relevant conditions of Rule 144 with respect to the particular securities that are being hedged. In the latter case, because the holder and/or its counterparty would be relying on the Rule 144 safe harbor rather than the Hedging Safe Harbor, and because outright sales of the restricted or control securities would at the time be permitted under Rule 144, the subsequent use of the restricted or control securities to close-out or cover hedge-related sales (*e.g.,* by delivery of the restricted or control securities held to the dealer counterparty or to the lender of securities borrowed to effect such sales) should be permitted. This position is entirely consistent with the view expressed by the Commission in its Interpretive Release with respect to "short sales against the box" (in particular, note the Commission's responses to Questions 80, 81 and 82 of the Interpretive Release). **27** To clarify that this result would pertain, the Committees urge the Commission to state that the position reflected in its April 1991 no-action letter to Bear Stearns & Co. Inc. regarding the covering of put options no longer applies and is reversed. **28**

As discussed above, the proposed Hedging Safe Harbor would apply to a holder of restricted or control securities entering cash-settled Hedging Transactions with respect to such securities or securities of the "same class". In order to determine whether the securities are of the "same class", the Committees would look to the standards set forth in Rule 144A. In order to be eligible for resale under Rule 144A, a security may not, "when issued, [be] of the same class as securities listed on a national securities exchange . . . or quoted in a U.S. automated inter-dealer quotation system . . . ." For purposes of Rule 144A, a convertible or exchangeable security would not be considered to be of the same class as the security into which it may be converted or exchanged if the effective conversion or exchange premium is at least 10%, and a warrant would not be considered to be of the same class as the security for which it may be exercised if the exercise period is at least three years or the effective exercise premium is at least 10% (determined, in each case, at the time of issuance).

If the restricted or control securities held are not of the same class as the underlying securities that are the subject of a Hedging Transaction, such Hedging Transaction should not be treated as the equivalent of the sale of such restricted or control securities and, therefore, could be effected immediately without registration under the Securities Act or reliance on Rule 144 or the Hedging Safe Harbor. Thus, for example, a holder of a privately placed convertible security with an effective conversion premium of 10% or greater may enter into a Hedging Transaction with respect to the securities underlying the convertible security without registration of the restricted or control securities held without any waiting period. The fact that the underlying security meets the Rule 144A 10% standard by itself demonstrates a sufficient difference in economics to avoid registration concerns. Any other approach would have a significant adverse impact on the market for privately placed convertible securities and, in particular, would severely disrupt the Rule 144A convertible securities market.

Finally, the Committees would suggest that the proposed Hedging Safe Harbor would also explicitly state that the safe harbors provided thereby could not be relied on for Hedging Transactions that, although in technical compliance with the terms thereof, is part of a plan or scheme to evade the registration requirements of the Securities Act. Moreover, the Hedging Safe Harbor would not provide any relief from the antifraud or antimanipulation provisions of the Securities Act or other securities laws.

F. Registration of Hedge-Related Sales.

In connection with certain Hedging Transactions, the initial hedge-related sales[29] made by the dealer counterparty may fall outside of those permitted by the Hedging Safe Harbor proposed above and might otherwise appropriately be registered. In such cases, the counterparty may seek to register such hedge-related sales under the Securities Act. The Committees, however, advocate the adoption of a new registration safe harbor (the " Registration Safe Harbor") that would clarify registration and prospectus delivery requirements in such cases.

The Hedging Transactions addressed in this letter all result in a transfer of the economic risk of a long position in restricted or control securities from the holder thereof to the counterparty, which is generally a derivatives dealer. The dealer then generally seeks to hedge its own new "synthetic long" position created by the Hedging Transaction.

The most common Hedging Transaction currently involves the dealer or a securities dealer affiliate, selling (generally, in a short sale) the underlying security. Where the dealer has acquired all of the economic interest of the notional amount of the underlying security (*e.g.*, in a "total rate of return" swap) it (or an affiliate) will generally sell immediately a number of underlying securities equal to the full notional amount and will not thereafter adjust its hedge before the termination of the Hedging Transaction. If, however, the dealer acquires less than all of the economic risk of the notional amount of the underlying securities (*e.g.,* in an option or collar transaction), the dealer (or an affiliate) would generally initially sell only a portion of the notional amount (such portion being determined by the dealer's internal models, which, among other things, take into account (i) the amount of the economic risk of the notional amount that the dealer is acquiring, and (ii) the probability that the option or other Hedging Transaction will terminate "in-the-money"). Thereafter, throughout the life of the Hedging Transaction until its termination, the dealer will engage in so-called "dynamic hedging" of its own risk by adjusting its own hedge, generally by buying or selling the underlying security based on its hedging model, changes in the price of the underlying security and the amount of time remaining until termination. Significantly, this dynamic hedging affects only the dealer counterparty's own risk and has no impact on the position of the holder of the restricted or control securities.

The Committees' proposed Registration Safe Harbor would provide that in cases where a dealer counterparty sought registration of its immediate initial selling activity of the entire notional amount of securities underlying a Hedging Transaction, such entire amount would have to be registered (and a prospectus delivered for such sales). However, in cases where the dealer counterparty acquired less than the entire economic risk of the notional amount of the underlying securities, the Registration Safe Harbor would require registration (and prospectus delivery) only of the initial sales, which would be expected to be less than the full notional amount.

The amount of the initial sales to be subjected to registration and prospectus delivery could be measured by relying on the dealer counterparty's model or, if preferred by the Commission, by aggregating all sales made by the dealer counterparty prior to (and in connection with) the Hedging Transaction together with those sales made by the dealer counterparty during any pricing period of the Hedging Transaction and for a short fixed period (such as five trading days) thereafter. By following this approach the Commission would be following the proper theoretical approach of subjecting to registration only those sales that directly and automatically result from the Hedging Transaction in question with the holder of the restricted or control securities. Subsequent activity by the dealer counterparty in dynamically hedging its own risk is "caused" by the Hedging Transaction only in an attenuated "but for" sense and has no relation to or impact on the position, economic or otherwise, of the holder of the restricted or control securities with whom the Hedging Transaction was entered. Purchases and sales in connection with a dealer's dynamic hedging resemble a dealer's market making activity following completion of a registered public offering. In such cases, the market making activity is caused (on a "but for" basis) by the offering, but is entirely for the dealer's account and has no relation to or impact on the issuer or seller in the offering. Clearly and significantly, such post-offering market making is not subject to Securities Act registration. The Committees believe that the same analysis and conclusion also properly applies in the case of dynamic hedging.

By adopting the Registration Safe Harbor, the Commission would address uncertainties faced by dealers conducting dynamic hedging as to whether the registration and prospectus delivery requirements apply, including (1) the inability to predict the volume of securities that would be required to be registered; (2) the inability to conduct adequate due diligence on an on-going basis; and (3) the inability to conduct dynamic hedging if an issuer demands, as is customary, registration blackout periods or if a current prospectus cannot otherwise be provided.

The Committees also recommend as part of the Registration Safe Harbor that if initial hedge-related sales are registered by the dealer counterparty under the Securities Act, (i) such sales should not be integrated with any other offers or sales made by the dealer counterparty, the holder of the restricted or control securities, the issuer of such securities, or their respective affiliates, and (ii) no further registration or prospectus delivery should be required in connection with the return to a lender of securities borrowed to cover such registered sales.**30** The Committees also recommend that the Registration Safe Harbor expressly provide that subsequent hedge-related sales (*i.e.*, hedge-related sales made to maintain or adjust the dealer counterparty's original hedged position through dynamic hedging) would not be integrated with, or aggregated for purposes of Rule 144 with, other offers or sales made by the dealer counterparty, the holder of the restricted or control securities, the issuer of such securities, or their respective affiliates.

Finally, the Registration Safe Harbor should also make clear, by analogy to the Commission's responses to Questions 80, 81 and 82 of the Interpretive Release and the position suggested above in the text at note 27, that underlying restricted or control securities equivalent to those whose sale is registered under the Registration Safe Harbor in connection with the Hedging Transaction should, in the case of non-affiliates, be treated as unrestricted and, in the case of affiliates, while still control securities, should without further restriction be deliverable by the holder to the counterparty to the Hedging Transaction and usable by the counterparty to close out its borrowing transaction.

G. The Committees Specific Responses to the Questions Posed in the Release

1. Hedge Prohibition. The Commission questions whether the Rule 144 safe harbor should be unavailable for persons who hedge during the holding period or, if not totally barred, whether there should be a shorter holding period (*e.g.*, three or six months) during which hedging would be prohibited (*i.e.*, hedging within this period would result in the loss of the Rule 144 safe harbor).

As discussed above, the Committees believe that the Rule 144 safe harbor should continue to be available to persons who engage in Hedging Transactions during the Rule 144 holding period. Moreover, the Committees do not believe that the Commission should act to preclude the ability to engage in Hedging Transactions for any mandated length of time. The Committees do believe, however, that a holding period concept could usefully be incorporated as an element of a safe harbor as one of the means to demonstrate that the entry into a Hedging Transaction by a person holding restricted securities should not be viewed as part of a distribution of such securities. As set forth in the proposed Hedging Safe Harbor, the Committees believe that three months is a sufficient length of time for such purpose, but that other means, such as the 10% price exposure test, would also adequately demonstrate that sufficient exposure to risk has existed or exists and no distribution of the restricted securities is involved.

2. Definition of Sale. The Commission queries whether there should be a definition of "sale" for purposes of Section 5 that would include specified types of Hedging Transactions.

The Committees do not believe that the Commission should attempt to define "sale" or "hedging" by rule for purposes of Section 5. Rather, the Committees believe the proper approach is to proceed by means of general interpretive guidance and the adoption of safe harbors. The Committees have proposed the Hedging Safe Harbor for this purpose. As proposed by the Committees, the Hedging Safe Harbor would treat Hedging Transactions in which the holder of the restricted securities position retained at least 10% price exposure or which take place after a period of three months has elapsed from the time the securities were issued or acquired from an affiliate as not constituting part of a distribution of the restricted securities. In the case of affiliates, volume limitations would also be applied to preserve the purposes served by Rule 144.

3. Treatment of Hedging Transactions. The Commission requests comment as to whether there should be a difference in treatment between (i) derivative securities that are "in-the-money" and those that are "out-of-the-money", (ii) cash-settled derivative instruments and those that are settled by physical delivery of the underlying security, (iii) the initial hedging transaction undertaken in connection with entering into a Hedging Transaction and subsequent transactions undertaken to adjust a hedge, and (iv) control securities and restricted securities.

a. *"In-the-Money" v. "Out of the Money"* . As evidenced in the proposed Hedging Safe Harbor, the Committees believe that there should be some difference in treatment between Hedging Transactions that are "in-the-money" and those that are "out-of-the-money". The degree of exposure to risk of a holder should be an element of analysis, and only transactions where substantially all economic risk is eliminated should be examined to determine whether an indirect distribution is involved. In addition, the Committees believe that the entry by a holder of restricted or control securities into a Hedging Transaction whereby the holder retains 10% price exposure should be eligible for protection under their proposed Hedging Safe Harbor.

b. *Cash-Settlement v. Physical Settlement*. The Committees believe that physical settlement can be a factor in assessing whether a Hedging Transaction has a "distributive" impact that would raise questions regarding registration under the Securities Act. The Committees therefore believe that whether any market selling activity was directly caused by such a transaction should be evaluated on a case-by-case basis. In order to limit the proposed Hedging Safe Harbor to transactions that are clearly not part of a distribution, the Committees have limited the Hedging Safe Harbor to cash-settled Hedging Transactions.

c. *Initial Hedge v. Subsequent Adjustments*. The Committees believe that the transactions used to establish the initial hedged position of a dealer counterparty should be analyzed differently from subsequent transactions by such counterparty to adjust its hedged position. The Committees have attempted to articulate this difference in the discussion above of the proposed Registration Safe Harbor. As noted in such discussion, if a dealer counterparty acquires less than all of the economic risk of the notional amount of the securities underlying a Hedging Transaction, the dealer would generally initially sell only a portion of the notional amount and would, thereafter, adjust its position through dynamic hedging. Because such dynamic hedging affects only the dealer counterparty's own risk and has no impact on the position of the holder of the restricted or control securities, the Committees believe that such subsequent sales should not be integrated or aggregated with offers or sales made by the holder of the restricted or control securities, nor with other offers or sales made by the dealer counterparty, the issuer of the restricted or control securities, or their respective affiliates.

d. *Restricted Securities v. Control Securities*. As noted in Part II.B., the Committees recognize that the purposes served by Rule 144 are different depending on whether the securities in question are restricted or control securities. The Committees therefore support the distinction between restricted securities and control securities and have preserved this distinction in the Hedging Safe Harbor proposed above.

4. Tolling of the Holding Periods. The Commission queries whether there should be a reintroduction of the holding period tolling concept that was deleted in 1990.

The Committees' view with respect to the reintroduction of the holding period tolling concept is discussed at length in the 1995 Comment Letter. In short, the Committees strongly oppose such suggestion and believe that reintroduction of the tolling concept is unnecessary and would prove unduly burdensome and, in the end, unworkable. Rather, the Committees believe the adoption of an interpretive and safe harbor approach to Hedging Transactions, like the one suggested above, is the appropriate action to take.

III. THE REGULATION S RELEASE

A. Background.

Regulation S was adopted by the Commission in 1990 to clarify the application of the Securities Act's registration requirements to global securities offerings. Rule 901 of Regulation S contains a general statement to the effect that the registration requirements of Section 5 shall be deemed not to apply to offers and sales of securities that occur outside the United States. To assist in the determination of whether an offer or sale has occurred "outside the United States", Regulation S provides two nonexclusive safe harbors from Securities Act registration: one for offerings by issuers, distributors and their respective affiliates (the "issuer safe harbor")**31** and one for resales by persons other than issuers, distributors and affiliates (the "resale safe harbor"). Preliminary Note 2 to Regulation S states, however, that "Regulation S is not available for any transaction or series of transactions that, although in technical compliance with [Regulation S], is part of a plan or scheme to evade the registration provisions of the [Securities] Act."

Since 1990, the Commission has become increasingly concerned that Regulation S is being used in situations not contemplated by the rule. Accordingly, in June 1995, the Commission issued an interpretive release (the "1995 Regulation S Release") that discussed certain "problematic practices" involving equity securities of U.S. issuers that had arisen under Regulation S and requested comment as to whether Regulation S should be amended to curb such perceived abuses.**32** The Regulation S Release was issued to address the Commission's continuing concern regarding the use of Regulation S and to respond to comments received with respect to the 1995 Regulation S Release.

The Regulation S Release notes that the Commission's "primary area of concern has been the use of Regulation S for sales of equity securities by [U.S.] issuers." The Commission believes that such issuers may be using Regulation S as a "guise for distributing securities into the U.S. markets without the protections of Section 5 of the Securities Act." Accordingly, the Commission is proposing to amend Regulation S by modifying the safe harbor procedures for placements of equity securities by U.S. issuers. In addition, because the Commission believes that "there is equal potential for abuse where the principal trading market for securities [of non-U.S. issuers] is in the United States," the Commission is also proposing to amend the safe harbor procedures for placements of equity securities by non-U.S. issuers where the United States constitutes the principal trading market for such securities. The Commission proposes that the United States be deemed to be the "principal market" for securities of non-U.S. issuers if more than 50% of the trading volume takes place in the United States, but requests comment as to whether such test or suggested percentage is appropriate. Equity securities of U.S. issuers and of non-U.S. issuers where the United States is deemed to constitute the principal market (or that are otherwise proposed to be covered by the amended safe harbor procedures) are referred to as "covered equity securities".

The Commission also requests comment with respect to its proposals to (i) lengthen the Regulation S restricted period for covered equity securities from 40 days (in the case of reporting issuers) or one year (in the case of non-reporting issuers) to two years, thereby aligning the Regulation S restricted period for such securities with the Rule 144 holding period; (ii) impose on covered equity securities certain certification, legending and other requirements; (iii) require purchasers of covered equity securities to agree not to engage in hedging transactions with regard to such securities unless such transactions are in compliance with the Securities Act; **33** (iv) prohibit the use of promissory notes as payment for covered equity securities; (v) classify covered equity securities as "restricted securities" within the meaning of Rule 144; and (vi) provide that offshore resales of covered equity securities would not affect the status of such securities as "restricted securities" for purposes of Rule 144 (*i.e.,* offshore resales would not "wash off" the restrictions).**34**
The Committees' responses to the Commission's requests for comment are set forth below.

B. Proposed Amendments to the Issuer Safe Harbor35

1. Modifications of the Provisions Relating to Offerings of Covered Equity Securities.
Several of the Commission's proposed changes to the issuer safe harbor would be effected by moving offerings of covered equity securities from Category 2 to Category 3 and by modifying certain of the provisions currently contained in Category 3.

Under the proposed amendments, the current one-year restricted period imposed on Category 3 equity offerings would be lengthened to two years in the case of covered equity securities. In addition, new restrictions would be added to Category 3 that would require distributors and purchasers of covered equity securities to agree not to engage in hedging transactions except in compliance with the registration requirements of the Securities Act or an exemption therefrom. The certification, legending, stop-transfer and notification requirements currently contained in Category 3 would be retained with certain minor modifications (which, for the most part, are designed to clarify that, in addition to Regulation S transactions, transfers of Category 3 securities may also be made in accordance with the registration requirements of the Securities Act or an available exemption therefrom).

The Committees are strongly supportive of the Commission's proposal as an appropriate means of addressing abuses in offerings of covered equity securities of U.S. issuers that Regulation S was not intended to countenance. As further discussed below, however, the Committees believe the abuses which have prompted the Commission's proposals in the case of covered equity securities of U.S. issuers are not at all evident in the case of non-U.S. issuers and that the new proposed Category 3 restrictions and procedures (*e.g.,* the legending requirement) are difficult -- if not impossible -- to comply with in the case of non-U.S. issuers with any non-U.S. market for the securities in question. Accordingly, the Committees urge the Commission to adopt a definition of "covered equity securities" that does not unfairly and unnecessarily burden non-U.S. issuers with non-U.S. trading markets. **36** Moreover, the Committees believe that, without weakening the impact of the Commission's proposals in deterring abuses under Regulation S, rather than mandating specific certification, legending, and stop-transfer procedures that must be used in order to rely on the safe harbor (which procedures may, in many instances, be impractical or even illegal in certain non-U.S. markets), the Committees suggest the imposition of a requirement that reasonable procedures be adopted to notify purchasers of the U.S. resale restrictions applicable to covered equity securities. For example, a restricted global security or depositary facility (like the one administered by The Depository Trust Company (" DTC") for Rule 144A securities offerings) could be used to implement resale restrictions without requiring that issuers issue legended physical certificates or amend their charters to include stop-transfer provisions.

2. Treatment of Non-U.S. Issuers with a "Principal Market" in the U.S. Although the Commission states that "abusive practices under Regulation S have not been as evident in offerings by non-U.S. issuers," the Commission's proposed changes would be imposed not only on U.S. issuers, but also on non-U.S. issuers where the "principal market" for the subject securities is in the United States. The Commission would deem the United States to be the "principal market" for such securities if "more than 50 percent of all trading in such class of securities took place in, on or through the facilities of securities exchanges and inter-dealer quotation systems in the United States in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation."

The new Category 3 restrictions and procedures and the "restricted securities" classification (collectively, the "Category 3 restrictions") would apply to all types of equity securities offerings by non-U.S. issuers (or their affiliates) where the United States is the principal market, including an offering taking place entirely outside the United States. The Commission requests comment, among other things, as to (i) whether "principal market" should be determined by reference to a percentage that is higher or lower than 50%, (ii) whether the Category 3 restrictions should be applied to all non-U.S. issuers regardless of where the principal market is, (iii) whether the Category 3 restrictions should cover only non-U.S. reporting issuers with "substantial U.S. market interest" in the subject securities, (iv) whether the Category 3 restrictions should cover only non-U.S. reporting issuers whose sole equity market is in the United States, (vi) whether a test other than one based on the principal trading market (*e.g.,* one based on a percentage of U.S. resident ownership) should be used, (vii) whether the test should be based on an "average daily trading volume" test such as the one adopted by Exchange Act Regulation M, and (viii) whether a different measurement period should be used.

The ultimate resolution of this definitional question is likely to have a significant impact on the attractiveness of the U.S. markets, especially the public market but also the private institutional market, and on a large number of non-U.S. issuers, particularly those from Canada**37** and certain emerging markets. The increased globalization of securities trading has prompted a growing number of non-U.S. companies to list their equity securities on securities exchanges in both the United States and their home and other non-U.S. markets. This trend has been beneficial to U.S. markets, U.S. investors and U.S. market participants. Should the Commission adopt a definition of "covered equity securities" that includes securities of non-U.S. issuers that have a non-U.S. trading market, such non-U.S. issuers will be faced with the choice of either (1) registering under the Securities Act 100% of their equity securities offered and sold outside the United States (including in offerings conducted entirely outside the United States), because these issuers cannot implement the restrictions and procedures that the Commission's proposals would mandate under Regulation S[38], or (2) avoiding U.S. listing or Nasdaq quotation or otherwise introducing their securities into the U.S. trading markets.[39] Thus, the Committees are extremely concerned that the Commission's proposal will only serve to reverse the recent trend toward globalization by discouraging and deterring non-U.S. issuers from entering the U.S. markets (or penalizing them for taking such a step), rather than, as the Commission has done in the past, encouraging and facilitating such access.

Adopting the Commission's current proposal for applying the new Category 3 restrictions to equity securities of non-U.S. issuers with a 50% U.S. trading market, or indeed adopting any amendment to Regulation S that applies the new Category 3 restrictions to the equity securities of any non-U.S. issuers that trade outside the United States, would not be in the interests of U.S. markets, U.S. market participants or U.S. investors. Application of the new rules as proposed will discourage non-U.S. issuers that would otherwise comply with U.S. public market disclosure and other U.S. rules from accessing the U.S. markets because of the potential interference of the new rules with such issuers' completely legitimate activities outside the United States (*e.g.,* offerings conducted in the home market or otherwise outside the United States; local market acquisitions using stock). Further, the proposed new rules restricting the non-U.S. activities of non-U.S. issuers could come into play at any time after such an issuer accesses the U.S. market, merely because of changes in market activity in U.S. and home markets, and without any action or control by the issuer.[40] At the same time, the Commission concedes (and the Committees agree) that no evidence exists that the abuses under Regulation S that the Commission condemns and is determined to stop (and that the Committees also condemn and agree should be stopped) exist in respect of equity securities of non-U.S. issuers. In the face of these considerations, the Committees conclude that the new Category 3 restrictions should not apply to non-U.S. issuers with any non-U.S. trading market.

Applying the Category 3 restrictions to such non-U.S. issuers would also be contrary to the principles of comity that the Commission has heretofore embraced. On a number of occasions in recent years the Commission has adopted measures or followed policies designed to minimize unnecessary impact on activities outside the United States. Examples include Regulation M and Rule 15a-6 under the Exchange Act, Rule 144A and the provisions of Regulation S heretofore applicable to non-U.S. issuers. Thus, applying the proposed Category 3 restrictions to equity securities of non-U.S. issuers with a non-U.S. trading market would be an unfortunate and unjustified departure from the Commission's recent emphasis on the principles of comity, especially given the fact that there are no perceived abuses against which the Commission would be acting.

Accordingly, the Committees urge the Commission to proceed incrementally -- to act aggressively to halt perceived abuses by U.S. issuers, while taking a more cautious approach in the case of non-U.S. issuers, where there is no evidence of similar abuses. Specifically, the Committees believe that securities of issuers that satisfy the definition of "foreign private issuer" contained in Exchange Act Rule 3b-4 should be excluded from the definition of "covered equity securities" unless the securities are not traded (or, in the case of an initial public offering, offered) in a non-U.S. trading market and the U.S. therefore comprises the sole trading market for such securities. Because the Commission itself acknowledges that it "is not aware of widespread abuses involving these foreign issuers" and for the other considerations discussed above, the Committees believe that such a narrowly-drawn standard is appropriate.

Both the Commission and the Committees have access to only incomplete statistical information regarding the extent to which the U.S. would, under the Commission's proposal (and, indeed, under any percentage-based approach), comprise the "principal market" for the securities of non-U.S. issuers, but the information presently available suggests that U.S. trading volume can be significant for many non-U.S. issuers, particularly those from important emerging markets. Ironically, such issuers are the very ones that should be (and, in the past, the Commission has) encouraged to access the U.S. markets. Under these circumstances, the Committees believe that adopting any standard for including the securities of non-U.S. issuers as covered equity securities that relies on the percentage of trading volume in the U.S. will lead to uncertain, unpredictable and potentially very harmful consequences. The Committees therefore oppose the adoption by the Commission of any such standard, whether at the 50% level or a higher level.

Finally, the Committees urge that in any case "overseas directed offerings" (as defined in Rule 902 of Regulation S), which are currently classified as Category 1 offerings, also be exempt from Category 3 restrictions. Based on principles of comity, the lack of perceived abuses, and the nature of the activity wholly in a non-U.S. market, such offerings should continue in all cases to fall within Category 1.

3. Elimination of the Form 8-K Filing Requirement. The Commission recently adopted amendments requiring that U.S. reporting companies report on Form 8-K sales of equity securities effected pursuant to Regulation S within 15 days of such sale.**41** Because it is proposing to lengthen the restricted period with respect to offerings of covered equity securities, the Commission is now proposing to modify this reporting requirement by amending Item 701 of Regulation S-K to require that reports of such sales be made on a quarterly basis as is currently required for other unregistered sales of equity securities.

Assuming the proposal with respect to the lengthening of the restricted period for covered equity securities is adopted, the Committees agree that current reporting on Form 8-K would be unnecessary and would support quarterly reporting of sales of such securities on Form 10-Q.

4. Use of Promissory Notes and Other Non-Cash Payments. The Commission proposes that Category 3 also be amended to clarify that the issuer safe harbor would not be available for offerings of covered equity securities in which the purchaser delivers a promissory note as payment for all or part of the purchase price or enters into an installment purchase contract relating to the sale. The Commission, however, requests comment, among other things, as to (i) whether there should be any exception to this prohibition to accommodate established international offering practices, (ii) whether there should be any distinction between full and non-recourse promissory notes, (iii) whether, rather than prohibiting the use of promissory notes as payment, the Commission should apply the Rule 144 tolling concept to such situations, and (iv) whether the Regulation S safe harbor should only be available when cash is paid and received in the offering.

While the Committees do not object to the proposal in the case of U.S. issuers, they believe that the classification of covered equity securities as "restricted securities" for purposes of Rule 144 obviates the need for additional restrictions on the use of promissory notes and other non-cash payments within the context of Regulation S. The Committees believe that an equally effective approach might be to adopt the proposal that covered equity securities are "restricted securities" under Rule 144 and to provide that the holding period does not run until full consideration for the securities is paid. The Committees also note that if the Commission does not narrow the definition of covered equity securities to exclude securities of non-U.S. issuers with any non-U.S. trading market, this restriction would be inconsistent with the "partial pay" offerings that are conducted by non-U.S. issuers on occasion.

5. Classification of Covered Equity Securities as "Restricted Securities". The Commission is proposing to add a new Rule 905 to Regulation S (and make conforming changes to Rule 144) to classify covered equity securities as "restricted securities" within the meaning of Rule 144. The Regulation S Release states that by "expressly defining these Regulation S securities as falling within the definition of 'restricted securities' under the Rule 144 resale safe harbor, purchasers of those securities are provided with clear guidance regarding when and how those securities may be resold in the United States without registration under the Securities Act."

The Committees support the Commission's suggested approach with respect to the classification of covered equity securities as "restricted securities", provided that the definition of "covered equity securities" with respect to non-U.S. issuers is significantly narrowed as discussed above.**42**

6. Securities Covered by the New Restrictions. As proposed by the Commission, the Category 3 restrictions would cover only "equity securities" issued by U.S. issuers and by non-U.S. issuers whose principal market is in the United States.**43** The Regulation S Release states that the Commission does not propose to apply the Category 3 restrictions to debt offerings "since the nature of the trading markets for debt securities appear not to have facilitated abusive practices that result in a distribution of these securities into U.S. markets." Nonetheless, the Commission queries whether the Category 3 restrictions should apply to debt securities. The Commission also requests comment as to whether certain equity securities, such as certain types of convertible or exchangeable securities or warrants, should be excluded from the Category 3 restrictions.

The Committees concur with the Commission's view that offerings of debt securities have not led to abusive practices and do not present the same potential for abuse that may exist in certain offerings of equity securities. Accordingly, the Committees agree that Category 3 restrictions should not be imposed on debt securities.

The Committees do, however, believe that certain convertible or exchangeable securities and warrants should be excluded from the new proposed Category 3 procedures and restrictions. Specifically, the Committees believe that *bona fide* convertible or exchangeable securities and warrants that are not fungible with the covered equity securities into or for which they may be converted, exchanged or exercised, should not themselves be treated as covered equity securities. In order to make such determination, the Committees would import the standards for fungibility currently used in determining Rule 144A eligibility. **44** (*i.e.,* a convertible or exchangeable security would be considered the same as, or fungible with, the security into which it may be converted or exchanged if the effective conversion or exchange premium is less than 10% and a warrant would be considered the same as, or fungible with, the security for which it may be exercised if the exercise period is less than three years or the exercise premium is less than 10%, determined, in each case, at the time of issuance). **45**

A significant and completely legitimate business purpose exists in connection with the issuance of such "non-fungible" convertible and exchangeable securities and warrants of U.S. issuers under Regulation S, and often in global offerings under both Rule 144A and Regulation S (*e.g.,* such offerings are often conducted to accommodate market timing). The Committees do not believe that these offerings have been subject to the abuses that have been evident in the case of some offerings under Regulation S of common stock of U.S. issuers or of convertible securities or warrants with terms that do not sufficiently distinguish them from the underlying common stock of U.S. issuers. However, the Committees also appreciate that the Commission is understandably attempting to protect against "flowback" into the U.S. public markets of covered equity securities that is effectively part of the initial distribution.

Many, if not most, of these offerings of non-fungible securities, where the underlying security is a covered equity security, involve global offerings under Rule 144A in the United States and Regulation S outside the United States. In such cases, both tranches are (at least in the case of U.S. issuers) generally treated as a single issue of restricted securities. In any event, the Committees believe that where these offerings are legitimate, they are not intended or designed to represent indirect distributions into the United States.

The Committees would therefore propose that the following principles apply in the case of offerings under Regulation S of convertible or exchangeable securities and warrants where the underlying security is a covered equity security:**46**

(i) in all cases, such convertible or exchangeable securities and warrants would be restricted securities and be subject to new proposed Rule 905 (and thus eligible for resale into the U.S. public markets in accordance with the holding period and other requirements of Rule 144);

(ii) if such securities are not fungible with the underlying covered equity securities under the standards of Rule 144A, the proposed new Category 3 restrictions would not (except as otherwise set forth in clause (i) above) apply to such securities;**47** and

(iii) if such securities are fungible with the underlying covered equity securities under the standards of Rule 144A, the proposed new Category 3 restrictions would apply to such securities (*i.e.,* the offered securities would themselves be treated as "covered equity securities").

7. Discounts. The Commission notes that "many of the abusive practices under Regulation S appear to involve significant discounts," and requests comment as to whether certain discounted offers should be excluded from the Regulation S safe harbor.

The Committees agree with the Commission that "there are other means to curtail such practices without mandating the safe harbor sales take place at a specific price or within a range of prices." Indeed, the Committees believe that the Category 3 restrictions proposed by the Commission (with the modifications suggested herein) serve precisely that function and that additional restrictions limiting the size of the discount that may be offered in a particular transaction is unnecessary. Moreover, the size of a discount is necessarily reflective of the particular facts and circumstances involved in an offering (including, among other things, size of the offering, liquidity, and timing considerations) and the Committees believe that it would be inappropriate for the Commission to try to impose a general range or maximum discount that may be offered in such cases.**48**

C. Proposed Amendments to the Resale Safe Harbor

In the Regulation S Release, the Commission expresses its concern that "the more stringent requirements proposed for offshore offerings [under Rule 903] could lead to the development of abusive practices under the Rule 904 offshore resale safe harbor." Accordingly, as noted in Part III.B.5., the Commission is proposing to add a new Rule 905 to Regulation S to clarify that when covered equity securities are resold offshore under Regulation S (including in reliance on the resale safe harbor), such securities will retain their status as "restricted securities" within the meaning of Rule 144 (*i.e.,* the resale safe harbor cannot be used to "wash off" Rule 144 resale restrictions).

The Commission queries, however, (i) whether proposed Rule 905 is sufficient to deter the improper use of the resale safe harbor, (ii) whether, in addition to covered equity securities, other types of restricted securities (*e.g.,* restricted debt securities) should also expressly be considered "restricted securities" following a Regulation S resale, (iii) whether certain types of issuers or particular categories of covered equity securities (*e.g.,* certain types of convertible or exchangeable securities) should be exempt from such treatment, or (iv) whether the resale safe harbor should be made unavailable for resales of covered equity securities. In addition, the Commission notes that for purposes of the offshore transaction requirement of the current resale safe harbor, securities may be sold on a "designated offshore securities market" and questions whether it would be practical for such securities to be identified to the subsequent purchaser as being "restricted" for purposes of U.S. federal securities laws. **49**

The Committees agree that the resale safe harbor should not be used as a means to "wash off" restrictions on covered equity securities and believe that proposed Rule 905, by providing that covered equity securities resold pursuant to the resale safe harbor will retain their status as "restricted securities" for purposes of Rule 144, is sufficient to protect against subsequent indirect distributions into the United States. Thus, the Committees do not believe that elimination of the resale safe harbor for covered equity securities is warranted.

The Committees do not believe that it is necessary to apply proposed Rule 905 outside the category of covered equity securities. In particular, the Committees believe that existing practices under Regulation S provide appropriate protections against flowback into the United States for debt securities and that no "flow in" to the United States is apparent with respect to any securities of non-U.S. issuers. The Committees also believe that distributions should not be made based on an issuer's filing or reporting status. As noted above, however, the Committees would subject fungible convertible or exchangeable securities and warrants of U.S. issuers to Rule 905 where the underlying security is a covered equity security.

D. Hedging Activities.

In the Regulation S Release, the Commission reiterates its concern that "some hedging activity may undermine the safeguards against indirect distributions provided by Regulation S and Rule

144." In the Regulation S Release, however, the Commission queries whether it should go beyond its Rule 144 approach[50] and prohibit all hedging during the Regulation S restricted period. Alternatively, the Commission asks whether the ability to engage in Hedging Transactions should depend on the size of the issuer, whether the hedging occurs offshore or whether the Hedging Transaction is "out-of-the-money".

The Committees believe that the Commission's concerns regarding hedging activities in connection with Regulation S transactions will be sufficiently addressed by classifying covered equity securities as "restricted securities" for purposes of Rule 144 and adopting the Committees' approach to hedging discussed above, including its proposed Hedging and Registration Safe Harbors.[51]

If you have any questions or would like further information regarding this letter, please feel free to contact Mark A. Egert, Vice President and Associate General Counsel of the SIA and Staff Adviser to the Federal Regulation and Capital Markets Committees, at 212-618-0508.

Very truly yours,

C. Evan Stewart, Chairman
Federal Regulation Committee

Ralph L. Pellecchio, Chairman
Capital Markets Committee

Zachary Snow, Chairman
OTC Derivative Products Committee

cc:
The Honorable Arthur Levitt, Chairman
The Honorable Steven M. H. Wallman, Commissioner
The Honorable Norman S. Johnson, Commissioner
The Honorable Isaac C. Hunt, Jr., Commissioner
Brian J. Lane, Director, Division of Corporation Finance
Meredith B. Cross, Deputy Director, Division of Corporation Finance
Paul M. Dudek, Chief, Office of International Corporate Finance,Division of Corporation Finance

Footnotes

1 SIA is the trade association representing more than 750 securities firms headquartered throughout North America. Its members include securities organizations of all types--investment banks, brokers, dealers, specialists, and mutual fund companies. SIA members are active in all markets, and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of investment services and account for approximately 90% of the securities industry's revenue in the United States.

2 SEC Release No. 33-7391 (Feb. 20, 1997).

3 SEC Release No. 33-7392; 34-38315; International Series Release No. IS-1056 (Feb. 20, 1997).

4 In the Rule 144/145 Release, the Commission also requests comment with respect to possible regulatory approaches to the conduct of hedging activities engaged in by persons holding restricted and control securities. A discussion with respect to such hedging-related matters is set forth in Part II.

5 Although neither Section 2(11) nor Rule 144 defines the term "control", the term is defined in Rule 405 under the Securities Act and such definition has previously been used by the Commission staff in providing interpretive advice in connection with Rule 144. *See*, *e.g.*,American-Standard (Oct. 11, 1972). For purposes of Rule 405, "control" means the "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

6 H.R. Rep. No. 85, 73d Cong., 1st Sess. 13-14 (1933). *See also*, *e.g.*, Hicks,Resales of Restricted Securities (1996); Throop & Lane, "Some Problems of Exemption Under the Securities Act of 1933," 4 Law & Contemp. Probs. 89 (1937) (suggesting that "control" be found in persons who have the power to cause the issuer to file a registration statement). Section 6 of the Securities Act requires registration statements to be signed by, among others, the issuer of the securities to be registered.

7*See* Report of the Advisory Committee on the Capital Formation and Regulatory Processes (July 24, 1996).

8 The Preliminary Note to Rule 144 currently states that "where adequate current information concerning the issuer is available to the public, the rule permits the public sale in ordinary trading transactions of limited amounts of securities. . ." (emphasis added). The Committees note that the Commission's suggested removal of the prohibition against solicitation of orders by sellers (other than broker-dealers selling on their own behalf; see discussion below) of restricted or control securities would, in effect, treat privately-negotiated sales as public sales pursuant to which the recipient would immediately receive freely tradable securities. In order to preserve Rule 144 as a public resale safe harbor for market transactions, the Committees believe that the requirement of broker-dealer involvement and reliance on Section 4(3) or 4(4) should be retained.

9*See*, *e.g.*, Rule 2320 under the Conduct Rules of the National Association of Securities Dealers, Inc. (the "NASD").

10 In this connection, the Committees request that the Commission reverse those no-action positions in which a contrary view was expressed. *See*,*e.g.*, Insilco Corporation (avail. May 2, 1974); UniCapital Corporation (avail. Dec. 22, 1972). *See also*Goldman, Sachs & Co. (Dec. 16, 1993) (in which the staff denied a no action request with respect to whether riskless principal transactions would fall within the manner of sale provisions of Rule 144).

11 SEC Release No. 33-7187 (June 27, 1995) (the " 1995 Rule 144 Release").

12 In the event that the Commission is unwilling to enact such a change to Rule 144, the Committees would urge the Commission to add to the Rule a provision, similar to the one contained in Regulation D under the Securities Act, to the effect that the benefits of the safe harbor are not lost in the event of an inadvertent or insignificant failure to comply with the Form 144 filing requirement. *See* Rule 508 of Regulation D (the "failure to comply with a term, condition or requirement . . . will not result in the loss of the [Section 5] exemption . . . if [, among other things, the] failure to comply was insignificant with respect to the offering as a whole. . . ."). For the reasons stated in the text, the Committees believe that whether the Form 144 has been properly filed (though it serves as an informational and monitoring tool) should not be viewed as a significant factor in determining whether or not a safe harbor from registration under the Securities Act is available, especially where the failure is inadvertent or insignificant.

13*See* Division of Corporation Finance Manual of Publicly Available Telephone Interpretaions (Jan. 1997).

14*See*, *e.g.*,Standard Chartered Bank (avail. June 22, 1987) ("sales by a pledgee of securities pledged by a borrower would not be aggregated with sales of the securities of the same issuer by other pledgees of such borrower in the absence of concerted action by such pledgees"); Frost National Bank of San Antonio (avail. June 7, 1976) ("horizontal aggregation is not required by Rule 144(e)(3)(B) in the absence of concerted action by the pledgees"). See also SEC Release No. 33-6099 (Aug. 2, 1979) (the " Interpretive Release"), response to Question 48 ("Rule 144(e)(3)(iii) does not require horizontal aggregation [by donees] with other donees [of the same donor]").

15*See*, *e.g.*,Precision Optics Corporation, Inc. (avail. Jan. 14, 1993);Savin Rosen Bayless Borovoy (avail. Oct. 30, 1992). See also the Interpretive Release, response to Question 36 ("Rule 144(d)(4)(ii) permits tacking only if the consideration surrendered upon exercise of the warrants consists solely of other securities of the same issuer").

The Committees acknowledge that such tacking would not be permitted where the acquisition of the original securities did not involve any investment risk in the holder. *See*, *e.g.*, Hansen Natural Corp./Unipac Corp. (avail. Mar. 23, 1993); Malden Trust Corporation (avail. Feb. 21, 1989).

16*See*, *e.g.*,MBank Fort Worth N.A. (avail. Feb. 1, 1988); Bateman Eicher, Hill Richards, Incorporated (avail. Dec. 21, 1984);Morgan Stanley & Co. (avail. Nov. 29, 1984); Security Pacific National Bank (avail Jan. 24, 1983); Everest & Jennings International (avail. Nov. 19, 1981).

17 The Committees also request that the Commission make clear that, even where Rule 144(k) is not available (*e.g.*, because the two-year holding period has not yet run), the pledgee of restricted or control securities may, upon a default by the pledgor, sell such securities on its own behalf in compliance with the other applicable provisions of Rule 144 and may file the Form 144 in its own name and for its own account rather than that of the pledgor.

18*See* SEC Release No. 33-7390 (Feb. 20, 1997). Parallel changes shortening periods during which restrictions apply to one and two years have also been adopted with respect to Rule 145.

19 As discussed in Part II of this letter, the Committees believe that a shorter holding period of three months adequately demonstrates that a holder is taking sufficient economic risk with respect to a restricted securities position such that a cash-settled hedging transaction thereafter by a non-affiliate (and short sales into the market by the holder's counterparty) should not be viewed as part of an indirect distribution of the underlying restricted securities. Such a hedging transaction is not, however, a sale of the underlying restricted securities and, at least for the time being, the Committees believe that the newly adopted holding periods are the appropriate standards for the various factors (including the risk to which a holder is exposed) that should be taken into account in determining whether a sale is part of a distribution requiring registration.

20 In general, the maximum amount of securities that may be sold in any three month period is the greatest of the following three amounts: (i) one percent of the securities of the class outstanding; (ii) the average weekly reported volume of trading in the securities on all national securities exchanges and/or reported through the automated quotation system of a registered securities association during the preceding four calendar weeks; and (iii) the average weekly volume of trading in the securities reported through the consolidated transaction reporting system contemplated by Exchange Act Rule 11Aa3-1 during the preceding four calendar weeks.

21 The Committees note that trading volume figures are readily available from a variety of quotation vendors and other sources.

22 Specifically, the Commission proposes to eliminate paragraphs (c) and (d) of Rule 145.

23 In the release adopting Rule 144, the Commission stated that "[f]or the purpose of the rule, the doctrine of 'fungibility' will not apply." SEC Release No. 33-5223 (Jan. 11, 1972). The decision not to include the fungibility concept in Rule 144 was no doubt based in large part on the results of a Commission-sponsored report, which thoroughly examined the concept and rejected it. See "Disclosure to Investors: A Reappraisal of Federal Administration Policies Under the '33 and '34 Acts" (1969) (the " Wheat Report"). The Wheat Report stated that "the present 'fungibility concept' bears little relationship to the needs of investors for disclosure . . . [and] introduces an additional element of uncertainty into an already clouded situation." By abandoning the fungibility concept when it adopted Rule 144 in 1972, the Commission recognized that the inclusion of such concept would serve only to unnecessarily complicate the Rule and other laws governing the resale of restricted and other securities. Moreover, as noted in the 1995 Comment Letter, application of the concept would, among other things, wreak operational havoc because of the burdensome tracing that would be required, which would probably require a return to reliance on physical certificates, and would impair overall market efficiency and the ability to promptly settle transactions. Finally, the development of the integrated disclosure system, which did not exist in 1972, makes any argument for fungibility even less persuasive in light of the significant disadvantages and costs it would produce.

24 As noted above, the Committees favor the elimination of Rule 145's presumptive underwriter doctrine. However, if such provisions were retained, the Committees believe that holders of Rule 145 securities should be treated the same for purposes of the proposed safe harbors as holders of restricted securities.

25 As further discussed below, the "same class" determination would be based on the principles set forth in Rule 144A under the Securities Act ("Rule 144A").

26 Under principles of non-fungibility, a non-affiliate holding restricted and unrestricted securities or an affiliate holding restricted and control securities could designate a Hedging Transaction as relating to particular securities.

27 In connection with hedge-related sales by a dealer counterparty that comply with the holding period, volume, manner of sale, and information requirements of the Rule 144 safe harbor (to the extent that such requirements are, at the time, required by the Rule), the Committees request that the Commission consider waiving the Form 144 filing requirement by such dealer counterparty to the extent that the filing of the Form would otherwise be required by the Rule. Furthermore, in connection with such hedge-related sales, the Committees also request confirmation that, should the manner of sale limitations of the Rule not be eliminated as proposed in the Rule 144/145 Release, a broker-dealer would be permitted to effect (without losing the benefit of the Rule 144 safe harbor), such sales as principal on its own behalf and would not be required to effect such sales through another broker-dealer. See discussion in Part I.B.3.

28 Bear Stearns & Co. Inc. (avail. Apr. 4, 1991) (the "Bear Stearns Letter"). The Committees believe that if the manner of sale requirement is eliminated as proposed, or modified as suggested above, the Bear Stearns Letter would in any event cease to apply.

29 The "initial hedge-related sales" would be those that a dealer counterparty would initially enter into as a result of the entry into the Hedging Transaction.

30 The Registration Safe Harbor should also make clear that the securities returned to the lender to close-out or cover the registered short sales would be free of resale restrictions (*i.e.*, they would not be "restricted securities" under Rule 144).

31 The issuer safe harbor distinguishes between three "categories" of offerings. In general, "Category 1" currently encompasses debt and equity offerings by certain non-U.S. issuers where there is no "substantial U.S. market interest" (as defined in Rule 902 of Regulation S ("Rule 902")) in the offered securities; certain overseas directed offerings; offerings of securities backed by the full faith and credit of certain non-U.S. governments; and certain securities offerings pursuant to a non-U.S. administered employee benefit plan. "Category 2" currently encompasses, in general, debt and equity offerings (other than those offerings that fall within Category 1) by U.S. and non-U.S. issuers subject to the periodic reporting requirements of the Exchange Act and debt offerings (other than those that fall within Category 1) by non-U.S. issuers not subject to Exchange Act reporting requirements. Finally, "Category 3" is, in general, a residual category that consists of offerings that do not fall within either Category 1 or 2. Specifically, Category 3 currently encompasses debt and equity offerings by U.S. issuers not subject to the periodic reporting requirements of the Exchange Act and equity offerings by non-U.S. issuers not subject to the periodic requirements of the Exchange Act if there is "substantial U.S. market interest" in the offered securities. The regulatory restrictions imposed on securities offerings under Regulation S increase as one moves from Category 1 to Category 3.

32*See* SEC Release No. 33-7190; International Series Release No. IS-821 (June 27, 1995).

33 A discussion of suggested regulatory approaches to hedging transactions is also contained in the Rule 144/145 Release. See Part II for the Committees' responses to the Commission's request for comment in connection with the Rule 144/145 Release's hedging discussion and Part III.D. for the Committees' responses to the Commission's Regulation S hedging-related inquiries.

34 The Commission is also proposing certain amendments intended to clarify certain provisions of Regulation S and make the rule easier to understand. Such proposed changes include the reorganization and rewording of certain provisions of the rule and the revision of the captions of the three subsections of the issuer safe harbor provision (contained in Rule 903 of Regulation S) to refer to them as they have become commonly known in the industry (*i.e.*, "Category 1", "Category 2" and "Category 3"; *see* note 31). The Committees are supportive of these efforts by the Commission to streamline and simplify the provisions of Regulation S.

35 Although the Commission states its belief that "abuses identified to date [do not] warrant precluding [U.S.] reporting issuers from making equity offerings under Regulation S", the Commission queries whether it would be more appropriate to end the safe harbor entirely for offerings of covered equity securities. The Committees agree that such drastic action would be inappropriate and might raise the costs of capital raising without producing a corresponding increase in investor protection. The Committees believe, as further discussed herein, that appropriate modifications may be made to Regulation S that would curtail perceived abuses without eliminating the safe harbor for covered equity securities entirely.

36*See* Part III.B.2.

37 The impact of the requirement to register would be reduced to some extent for those Canadian companies eligible to register their securities under the U.S./Canadian multijurisdictional system, which enables such issuers to use their home country disclosure together with, in most cases, a reconciliation of Canadian financial information to U.S. GAAP for purposes of filing in the United States. In most other cases, however, the requirement to register under the U.S. securities laws would be impractical and burdensome.

38 The proposed legending and stop-transfer and other requirements with respect to such securities, for example, would be inconsistent with the rules of many securities exchanges, depositary facilities and/or clearing agencies within and outside the United States.

39 The Committees note that a significant number of non-U.S. issuers would be captured by the Commission's proposed 50% principal market test -- indeed, many such issuers would also be captured by a 70%, 80% or even 90% test. The Committees believe that the comment letter submitted to the Commission by The Bank of New York (" BoNY"), dated April 28, 1997, regarding this issue is particularly telling. In its comment letter, which is supported by a statistical breakdown of trading volume in cases of non-U.S. issuers with U.S.-listed or Nasdaq-traded ADR programs on both a country-by-country and issuer-by-issuer basis, BoNY estimates that, based on its analysis of just one month's trading data, over one-third of all non-U.S. issuers with U.S.-listed or Nasdaq-traded ADR programs would be captured by the Commission's proposed 50% principal market test and a substantial number would even be captured by a significantly higher percentage test. For example, according to the statistics included in BoNY's comment letter, the U.S. trading volume of all Argentine issuers in the aggregate with U.S.-listed or Nasdaq-traded ADRs is in excess of 80% of total trading volume; for Brazil, Chile, Peru and Indonesia, the aggregate figures are in excess of 60%; for China, Hong Kong, Ireland, and Venezuela, the aggregate figures are in excess of 50%. A substantial number of significant individual issuers in these and other countries have U.S. trading volume well in excess of 50% of total trading volume. Importantly, neither the Committees, nor apparently the Commission, has perceived Regulation S abuses even in the case of these issuers with high U.S. trading volumes.

40 Such fluctuations in market activity, for example, could cause securities that were subject to "Category 1" offering restrictions under Regulation S when first offered, to become covered equity securities as a U.S. trading market for such securities subsequently develops.

41*See* SEC Release No. 34-37801; International Series Release No. IS-1020 (Oct. 10, 1996).

42 The Committees assume, however, that the Commission would apply new Rule 905 prospectively and that equity securities offered and sold prior to the adoption of such Rule would not retroactively become "restricted securities" for the purposes of the Rule.

43 As noted in footnote 44 of the Regulation S Release, however, Category 3 restrictions would not be applicable to non-participating preferred stock and asset-backed securities.

44*See* footnote 46 of the Regulation S Release and the discussion in Part II.E.

45 The Committees would also support clarification that a convertible or exchangeable security or warrant would not satisfy the standards for non-fungibility if it contained an unusual pricing provision that caused the conversion, exchange or exercise premium to change following issuance (e.g., as a function of market price), such that, if tested immediately or shortly after issuance, the offered security would not then meet the standards for non-fungibility.

46 For the reason discussed above, this approach is only workable without unnecessary interference with the non-U.S. activities of non-U.S. issuers if the securities of non-U.S. issuers with a non-U.S. trading market are excluded.

47 This approach would permit offerings using other measures developed under Rule 144A, Section 4(2) of the Securities Act and Regulation D thereunder that are designed to preclude a distribution, such as notices to investors of restrictions, use of global securities held in a depositary facility (such as DTC), and restrictions on trading in the United States to the private institutional markets (*e.g.*, to qualified institutional buyers under Rule 144A) through the use of "restricted" CUSIP numbers.

48 Indeed, should the Commission's proposals be adopted (even with the modifications suggested herein), the Committees do not believe that it would be unusual or surprising to see an increase in the size of the discounts offered due to increased illiquidity in the United States resulting from the imposition of such new restrictions.

49 For the reasons discussed above, the Committees do not believe that the securities of non-U.S. issuers with a non-U.S. trading market should be subject to Category 3 restrictions. The problems that inclusion of such securities would pose is particularly evident in the context of the resale safe harbor. The Committees do not believe that there is any practical way to inform the purchaser in such a sale (particularly in the case of sales on a "designated offshore securities market" (as defined in Regulation S)) of the resale restrictions imposed on such securities or to effectively police such resales, especially since legended securities are often not permitted in such markets. Moreover, a condition of the resale safe harbor is that transactions effected on a designated offshore securities market not be prearranged with a buyer in the United States. The Committees believe this limitation already sufficiently protects against potentially abusive practices effected in reliance on this element of the resale safe harbor.

50*See* Part II.

51 The Commission should also recognize in addressing hedging that market makers often engage in legitimate hedging transactions in connection with their market making activities. For example, in the context of a global offering of securities by a non-U.S. issuer under Rule 144A and Regulation S, dealers often purchase Rule 144A or Regulation S securities in their market making capacity and offset that risk by selling the underlying or a related security. Such hedges are generally unwound when a position purchased as a market maker is sold. Thus, any actions that the Commission takes or proposes regarding hedging should not interfere with the legitimate hedging activities of market makers, which do not lead to unregistered distributions.