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THE UNFOUNDED FEAR OF REGULATION S: EMPIRICAL EVIDENCE ON OFFSHORE SECURITIES OFFERINGS

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ABSTRACT

Regulation S provides U.S. issuers with an exemption from the registration requirements of the Securities Act of 1933 to the extent that securities are offered and sold solely outside the United States. Through resales back into the United States, however, U.S. investors may become exposed to unregistered securities initially distributed abroad through Regulation S. This Article identifies two distinct risks from an offshore securities offering. First, issuers may conduct an offering under Regulation S as a means to sell securities indirectly into the United States through resales in situations where the U.S. secondary market overvalues the issuer's securities. Second, even where the U.S. secondary market does not overvalue an issuer's securities, the managers of the issuer may utilize Regulation S to engage in self-dealing and other opportunistic behavior for their own private benefit at the expense of U.S. investors. Employing a dataset of 701 offerings conducted pursuant to Regulation S from 1993 to 1997, this Article presents evidence that insider self-dealing may result in a greater offering discount for certain overseas offerings. Given the specific risks facing U.S. investors, the Article then argues that the SEC's 1998 re-

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forms to Regulation S represent only an untailored response. Instead, the Article recommends specific reforms that both reduce the risk facing U.S. investors and lessen the regulatory burden on offshore securities offerings that pose little risk of investor abuse.

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INTRODUCTION

Regulation S of the Securities Act of 1933 (Securities Act) exempts issuers seeking to sell securities outside the United States from several requirements of federal securities regulation.[1] Adopting a territorial approach, Regulation S presents domestic issuers with the choice to sell securities freely offshore while avoiding the registration requirements of the Securities Act.[2] This choice, however, is not unlimited; through its focus on offerings outside the United States, Regulation S binds the U.S. regulatory regime to the U.S. capital markets. Issuers that desire to utilize Regulation S to avoid U.S.

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1. Regulation S encompasses Rules 901 through 905 of the Securities Act of 1933. *See* 17 C.F.R. § 230.901-905 (2000). The SEC originally adopted Regulation S in 1990. *See* Offshore Offers and Sales, Exchange Act Release No. 33-6863, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,524, at 80,661 (Apr. 24, 1990) [hereinafter Adopting Release]; *see also* Guy P. Lander, *Regulation S—Securities Offerings Outside the United States*, 21 N.C. J. INT'L L. & COM. REG. 339, 340-94 (1996) (providing a summary of the original Regulation S).

2. Rule 901 states that "[f]or the purposes only of section 5 of the Act (15 U.S.C. § 77e), the terms *offer, offer to sell, sell, sale,* and *offer to buy* . . . shall be deemed not to include offers and sales that occur outside the United States." 17 C.F.R. § 230.901 (2000); *see also* Offshore Offers & Sales, Exchange Act Release No. 33-6779, 53 Fed. Reg. 22,661, at 22,665 (June 17, 1988) [hereinafter Proposed Offshore Offers & Sales] ("The Regulation proposed today is based on a territorial approach to section 5 of the Securities Act. Under such an approach, the registration of securities is intended to protect the U.S. capital markets and all investors purchasing in the U.S. market, whether U.S. or foreign nationals."). Regulation S does not exempt issuers from any other aspect of the U.S. securities laws, including antifraud provisions under the Securities Exchange Act of 1934. *See* Preliminary Note 1, Regulation S, Securities Act, 17 C.F.R. § 230.901 (2000); *see also* Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207, 215-19 (1996) (discussing the reach of the U.S. antifraud liability rules overseas).

Section 5 of the Securities Act serves as the focal point for the Securities Act's registration requirement for offers and sales of securities. *See* 15 U.S.C. § 77e (1994). Commonly known as the gun-jumping rules, the registration process required under section 5 results in the creation of an information disclosure document known as the registration statement and the delivery of a subset of the registration statement, the prospectus, to investors. For most domestic companies, the registration statement consists of information contained on Form S-1, S-2, or S-3 of the Securities Act. *See* Forms S-1, S-2, S-3, 15 U.S.C. § 77 (describing Forms S-1, S-2, and S-3). Disclosure made through either the registration statement or the prospectus then comes under heightened antifraud liability pursuant to sections 11 and 12(a)(2) of the Securities Act. *See* 15 U.S.C. § 77e. Importantly, section 5 covers every offer and sale of a security that involves interstate commerce. Section 2(7) of the Securities Act, in turn, defines interstate commerce to include "trade or commerce in securities or any transportation or communication relating thereto . . . between any foreign country and any State, Territory, or the District of Columbia." *Id.* § 77b(7). Obtaining an exemption from section 5, such as through Regulation S, is therefore important for any transaction to escape the burdens of the registration process.

regulations must ordinarily do so without access to the U.S. capital markets.

Despite the territorial relationship between the U.S. regulatory regime and the U.S. capital markets within Regulation S, the securities laws afford issuers a potential loophole. Through resales into the United States, Regulation S allows for unregistered securities sold abroad to flow back into the United States.[3] A U.S. company operating out of New York, for example, may issue securities pursuant only to Japanese law through sales in Japan under Regulation S.[4] To the extent that the securities have "come to rest,"[5] Japanese investors may then resell into the United States, exposing investors within the United States to the risk of purchasing securities unregistered under the U.S. securities laws.

As originally promulgated, Regulation S guarded against the resale of unregistered securities into the United States by imposing a restricted period of forty days for equity securities of Securities Exchange Act of 1934 (Exchange Act) reporting issuers sold abroad, during which such securities could not be resold into the United States.[6] Many investors interpreted the forty-day restricted period to

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3. The focus of the registration process under section 5 is on particular transactions. Therefore, overseas investors may escape section 5's registration requirement and resell into the United States if they can find an applicable transaction exemption from section 5. Section 4(1) of the Securities Act provides such an exemption, exempting "transactions by any person other than an issuer, underwriter, or dealer." *Id.* § 77d(l).

To the extent that overseas investors can represent that they are not issuers, underwriters, or dealers, they may resell securities freely into the United States without meeting the registration requirement of section 5. *Id.* § 77d(l). The largest hurdle facing overseas investors in using section 4(1)'s exemption, in turn, is the definition of an underwriter under the Securities Act. Section 2(a)(11) defines an underwriter to include, among other things, "any person who has purchased from an issuer with a view to . . . the distribution of any security." *Id.* § 77b(11). Thus, overseas investors that purchase a Regulation S security with the purpose of reselling immediately into the United States are considered underwriters and are denied section 4(1)'s exemption from Regulation S. Absent some other exemption, such overseas investors must meet the registration requirement of section 5 in their resales into the United States.

4. Whether Japanese law applies to securities offerings inside Japan, of course, is a matter of Japanese law. *See* Nicole J. Ramsay, Note, *Japanese Securities Regulation: Problems of Enforcement*, 60 FORDHAM L. REV. S255, S257-65 (1992) (providing a summary of Japanese securities regulation); *see also* Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 STAN. J. INT'L L. 423, 428-44 (1994) (providing a history of securities regulation in Japan).

5. *See* Registration of Foreign Offerings, Exchange Act Release No. 4708, 29 Fed. Reg. 9,828, at 9,828 (July 9, 1964) ("It is assumed in these situations that the distribution is to be effected in a manner which will result in the securities coming to rest abroad.").

6. *See* Original Regulation S, 17 C.F.R. § 903(c)(2)(iii) (1990). Non-Exchange Act–reporting domestic issuers faced a one-year restricted period under the original Regulation S. *See id.* § 903(c)(3).

imply that resales into the United States could commence immediately after such period expired.[7] Despite the forty-day restricted period, the Securities and Exchange Commission (SEC) documented a series of abuses under the original Regulation S whereby securities sold offshore at large discounts ultimately made their way back into the United States.[8] In some cases, foreign investors engaged in short sales of the issuer's securities into the United States immediately following the Regulation S offering and then made up their short posi-

The Exchange Act imposes periodic information reporting requirements for certain issuers, commonly known as "Exchange Act–reporting companies." Companies listed on a national securities exchange must register and comply with the SEC's periodic information disclosure requirements. *See* 15 U.S.C. § 78m; *id.* § 78l(b); *id.* § 78c(a)(1) (defining "exchange" for the purposes of the Exchange Act). Similarly, companies whose total assets exceed $10 million and have a class of equity security (other than an exempted security) held of record by more than 500 shareholders must register the securities under the Exchange Act and thereby come under the periodic reporting requirements of section 13(a). *See id.* § 78m (requiring issuers of securities to file annual reports with the Commission); *id.* § 78l(g) (mandating an issuer's registering a registration statement with the Commission); *see also* 17 C.F.R. § 240.12g-1 (raising the asset requirement to $10 million).

These required periodic information filings include annual Form 10-K, quarterly Form 10-Q, and occasional Form 8-K documents. *See id.* § 78m(a) (giving the SEC authority to require these filings); Regulation 13A, Exchange Act, 17 C.F.R. § 240.13a-1–13a-17 (2000) (providing rules on periodic disclosure requirements of Exchange Act registered companies); *id.* § 249.310 (requirements for Form 10-K); *id.* § 249.308a (requirements for Form 10-Q); *id.* § 249.308 (requirements for Form 8-K). Companies that recently filed a registration statement that has become effective under the Securities Act must also comply with the periodic reporting requirements. *See* 15 U.S.C. § 78o(d).

7. Indeed, the SEC in the 1988 Proposing Release seemed to support the view that resales could commence into the United States after the Original Regulation S restricted period. *See* Proposed Offshore Offers & Sales, *supra* note 2, at 22,665 ("After the foreign distribution has been completed and the marketing efforts have terminated, routine secondary trading may begin as a matter of course. The periodic reporting requirements of the Exchange Act would protect investors in the U.S. market by assuring that information concerning the issuer would be available."); *see also* Sara Hanks, *Direct Regulation S Offerings and the SEC's "Problematic Practices" Release*, 2 STAN. J. L. BUS. & FIN. 303, 321 (1996) ("The author would suggest that the restricted period [of the Original Regulation S] raises a presumption against availability of Section 4(1) during its running, which presumption is reversed on the fortieth day.").

8. *See* Problematic Practices Under Regulation S, Exchange Act Release No. 33-7190, 60 Fed. Reg. 35,663, at 35,663 (June 27, 1995) [hereinafter Problematic Practices Release] (describing a number of harms to U.S. investors from Regulation S offerings); *see also* Josh Futterman, Note, *Evasion and Flowback in the Regulation S Era: Strengthening U.S. Investor Protection While Promoting U.S. Corporate Offshore Offerings*, 18 FORDHAM INT'L L.J. 806, 840-68 (1995) (discussing "flowback, evasion, and discounting problems since the adoption of Regulation S"); Julie L. Kaplan, Comment, *"Pushing the Envelope" of the Regulation S Safe Harbors*, 44 AM. U. L. REV. 2495, 2530-41 (1995) (delineating the exploitation of Regulation S and recommending lengthening the restricted period).

tion using securities purchased offshore, locking in any discount they obtained through purchases of offshore securities.[9]

To combat the possibility of resales into the United States, the SEC recently instituted new rules imposing numerous additional restrictions on Regulation S offerings.[10] Promulgated in 1998, the rules (referred to as the "1998 reforms"), among other things, effectively increased the period during which offshore investors must wait before selling equity securities of domestic issuers into the United States. Under the revised Regulation S, securities sold through Regulation S are considered "restricted."[11] Investors may not resell restricted Regulation S securities into the United States unless the transaction is registered under the Securities Act or satisfies the criteria of an exemption from the registration requirement. One such exemption is Rule 144 of the Securities Act,[12] which allows foreign purchasers to resell freely inside the United States so long as one full year has passed since the purchase of the securities, among other

9. Short sales involve investors selling securities they do not own into the market. Mechanically, to conduct a short sale investors must borrow the security from an intermediary and then sell the security into the market. Investors must eventually "cover" their short position at a later date by purchasing the security again on the open market and then delivering the security back to the intermediary. Short sales are profitable in situations in which the person engaging in the short sale expects the stock price to drop.

In a well-publicized case, the SEC issued a cease-and-desist order against GFL Ultra Ltd., a British Virgin Islands investment company. *See In re* GFL Ultra Fund Ltd., Exchange Act Release No. 7423, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,949, at 89,752 (June 18, 1997). GFL Ultra had engaged in several purchases of securities sold overseas through Regulation S typically at a discount of 15-20% of the U.S. secondary market price. Rather than wait until the expiration of the 40-day restricted period under the original Regulation S, GFL Ultra immediately engaged in short sales of securities of the issuer inside the United States. At the end of the 40-day restricted period, GFL Ultra then used its Regulation S securities to cover its short position. GFL Ultra, therefore, was able to guarantee a profit from its large discount from the U.S. secondary market price without any risk to itself through its short sale technique. *See id.* at 89,753 & n.5 (reporting that the total profit to GFL Ultra was greater than $840,000).

10. *See* Offshore Offers and Sales, Exchange Act Release No. 33-7505, 63 Fed. Reg. 9632 (Feb. 25, 1998) [hereinafter Offshore Offers & Sales]. The amendments embodied in Exchange Act Release No. 33-7505 became effective on April 27, 1998.

11. Rule 144 of the Securities Act defines a "restricted security" to include "[e]quity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions of § 230.901 or § 230.903 under Regulation S." 17 C.F.R. § 230.144(a)(3) (2000).

12. Rule 144 provides a safe harbor from the definition of an "underwriter" under the Securities Act for those who attempt to resell restricted securities. To the extent that the conditions of Rule 144 are met, an investor may then use the transaction exemption under section 4(1) of the Securities Act to avoid the registration requirement under section 5 of the Securities Act. *See* 15 U.S.C. § 77d(l) (1994); *id.* § 77e; 17 C.F.R. § 230.144; *see also supra* note 3 (discussing the registration requirements under the Securities Act and the section 4(1) exemption).

requirements.[13] The 1998 reforms also imposed certification,[14] legending,[15] and stop-transfer[16] restrictions on all Regulation S issuers and distributors of equity securities.

This Article argues that the SEC's 1998 reforms provide only an untailored response to the myriad problems posed through offshore securities offerings. The value of the SEC's 1998 reforms and the need to regulate the use of overseas offerings are inextricably linked to the risks to U.S. investors from resales of Regulation S unregistered securities into the United States. Armed with more detailed information on the danger posed through a Regulation S offering, regulators may implement tailored reforms that both reduce the risk to U.S. investors and lower the cost of capital for U.S. issuers seeking to raise capital offshore.

This Article groups the harms from a Regulation S offering into two theoretically distinct categories. First, managers may act in the best interests of the issuer's pre-offering shareholders. In this situation, managers of an issuer may use Regulation S to sell securities to foreign investors systematically where the secondary market overvalues the securities.[17] Through resales, the foreign investors may then resell such securities to unsuspecting U.S. purchasers, benefiting both foreign investors and the pre-offering shareholders of the issuer, at the expense of the new U.S. purchasers.[18] Significantly, the vulner-

13. *See* 17 C.F.R. § 230.144(d). In addition to the one-year holding period, Rule 144 requires several conditions before providing a safe harbor from the definition of an "underwriter" and, thereby, from the registration requirements of section 5. There must exist current public information on the issuer and the resale must occur through a "brokers' transaction," defined under section 4(4) of the Securities Act. *See* 15 U.S.C. § 77d(4) (making section 77e inapplicable to "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders"); 17 C.F.R. § 230.144(c) (requiring public information in form of filed reports); *id.* § 230.144(f) (outlining manner of sale of brokers' transactions); *id.* § 230.144(g) (defining "brokers' transaction"). As well, the amount of securities that may be sold in reliance on Rule 144 is limited. *See id.* § 230.144(e). A notice of the proposed sale is also required to be filed with the SEC. *See id.* § 230.144(h). On the other hand, for non-affiliate investors seeking to conduct a resale after two years from the date of acquisition, Rule 144 removes all of these additional requirements. *See id.* § 230.144(k).

14. *See infra* note 40 and accompanying text.

15. *See infra* note 41 and accompanying text.

16. *See infra* note 42 and accompanying text.

17. *See* Stewart Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187, 194-95 (1984) (describing the incentive of managers to sell securities where the secondary market price overvalues the company relative to its fundamental value).

18. Pre-offering shareholders gain to the extent that the issuer is able to take in a greater amount of offering proceeds due to the market's overvaluation. Foreign investors benefit to the extent that they receive a share of the overvaluation amount through an offering discount relative to the secondary market price U.S. purchasers pay for the securities. For a discussion of

ability of U.S. purchasers to resales of overvalued Regulation S securities depends on the accuracy and timing of the secondary market reaction to news of an offshore offering. Where the secondary market reacts accurately to news of the Regulation S offering prior to the commencement of resales into the United States, foreign investors lose the ability to resell overvalued securities to new U.S. purchasers.

Second, managers may act in their own self-interest through an offshore offering of securities. The offering discount, for instance, may represent an outright transfer of value from pre-offering U.S. shareholders in the issuer to foreign investors. To the extent that the managers own equity in the issuer, the managers are themselves diluted when securities are sold at a discount to foreign investors. Self-interested managers, therefore, will not ordinarily transfer value away from their own pre-offering shareholders to prospective foreign investors. Acting purely out of self-interest, nevertheless, managers may utilize Regulation S to engage in self-dealing, selling highly discounted securities to offshore entities in which the managers possess an ownership interest. Managers may also sell discounted securities to large block shareholders in the company in return for the block shareholders' acquiescence to self-interested managerial decisions. Similarly, managers may engage in sales of securities through Regulation S that raise capital for the issuer not needed for any shareholder wealth-increasing activity but rather designed to increase the power and prestige of managers.[19]

In one of the first empirical studies focusing on offshore securities offerings, this Article analyzes the magnitude of these potential harms using empirical evidence obtained from a dataset of Regulation S offerings involving Exchange Act–reporting issuers during the period from 1993 to 1997. The Article first summarizes evidence that foreign investors in fact are unable to resell foreign-issued U.S. securities ahead of the secondary market reaction to news of the offering, providing little support for the widely held fear that issuers may use Regulation S to issue overvalued securities indirectly to U.S. purchas-

these issues, see *infra* Part II.A.2 (analyzing the situation of resales of Regulation S securities into the United States prior to any secondary market reactions to information on the offering).

19. For example, managers may use the proceeds from a sale to engage in an acquisition designed to increase the amount of the assets under their control regardless of the value to shareholders of the acquisition. *See* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 599 (1989) (discussing the hypothesis that bidders in a takeover contest pay too much for the target company). Black writes, "These overpayments don't cause bidder stock prices to drop because investors already expect the bidder to waste the money, one way or another." *Id.*

ers.[20] The Article then presents evidence that the magnitude of the offering discount in an offshore offering increases with the fraction of corporate insiders on the board of directors, providing support for the notion that managers may use Regulation S offerings to transfer value to foreign investors as a form of self-dealing.[21] In addition, the greater the beneficial ownership of common stock on the part of corporate officers, the lower is the offering discount. The cost of using Regulation S to engage in self-dealing increases for managers that own a significant fraction of a corporation's equity.

Given the empirical evidence on the possible risks from Regulation S, this Article argues that the specific risks facing U.S. investors from a Regulation S offering require more tailored reforms that address the risks while reducing the restrictions on shareholder wealth-enhancing offerings. Regulators may wish to adjust the Regulation S exemption based on the type of issuer, whether the offering is conducted to a large number of purchasers or only a small group of purchasers, and the geographic region of the offering. In addition, more detailed and timely information disclosure on the identity of the purchasers of a Regulation S offering and the specific use of proceeds may lessen managerial opportunism risks, enabling regulators to reduce the restricted period applied to resales of offshore securities into the United States.

Part I of this Article provides a summary of the Regulation S offering exemption and the SEC's recent 1998 reforms. Part II discusses the theoretical risks U.S. investors confront from a Regulation S offering, and Part III reports this Article's empirical tests of the magnitude of the risks. Part IV then examines the possibility of policy reforms for Regulation S.

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20. *See infra* Part II.A (analyzing the risk to U.S. investors from resales of overvalued offshore securities into the United States); *see also* Problematic Practices Release, *supra* note 8, at 35, 663:

> Since the adoption of Regulation S, it has come to the Commission's attention that some market participants are conducting placements of securities purportedly offshore under Regulation S under circumstances that indicate that such securities are in essence being placed offshore temporarily to evade registration requirements with the result that the incidence of ownership of the securities never leaves the U.S. market.

21. *See infra* Part II.B (analyzing the risk to U.S. investors from the opportunistic use of offshore offerings of securities to benefit corporate managers).

I. SUMMARY OF REGULATION S AND THE IMPACT OF RECENT SEC REFORMS

The present justification for Regulation S relies on a concept of nationality that takes the goal of U.S. securities regulation as protecting American investors and capital markets.[22] So long as a securities transaction occurs within the United States, the U.S. securities regime should apply. If the transaction occurs solely "outside the United States,"[23] following this line of logic, there is no need for securities regulation to follow, and the offering is exempt from the registration requirements of section 5 of the Securities Act.[24] Regulation S, in turn, applies different standards for foreign and domestic issuers. This part discusses the requirements Regulation S places on domestic U.S. issuers.

Domestic issuers must satisfy a number of requirements, based on the type of transaction, in order to qualify for the Regulation S safe harbor.[25] Regulation S sets forth three categories of qualifying transactions, of which two are of primary importance to domestic is-

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22. *See* Proposed Offshore Offers & Sales, *supra* note 2, at 22,665 ("Principles of comity and reasonable expectations of participants in the global markets justify reliance on laws applicable in jurisdictions outside the United States to define disclosure requirements for transactions effected offshore.") (citation omitted).

23. 17 C.F.R. § 230.901 (2000).

24. *See supra* note 2 (describing the registration requirements under section 5 of the Securities Act).

25. In addition to the Regulation S requirements discussed in the text, all Regulation S issuers must also meet two basic requirements. First, any offers or sales must be made in an "offshore transaction" as defined in Rule 902(h) of the Securities Act. *See* 17 C.F.R. § 230.902(h). Rule 902(h) requires an offshore transaction to meet several prerequisites. Offers of Regulation S securities may not be made to a person inside the United States. *Id.* § 230.902(h)(1)(i). In addition, the transaction must meet one of two alternative requirements. The transaction must be "executed in, on or through a physical trading floor of an established foreign securities exchange that is located outside the United States." *See id.* § 230.902(h)(1)(ii)(B)(1). In the alternative, at the time the buy order is originated, purchasers of Regulation S securities must either be outside the United States or the seller must reasonably believe that the buyer is outside the United States. *See id.* § 230.902(h)(1)(ii)(A).

Regulation S issuers must then meet the second basic requirement that sellers cannot make any "directed selling efforts" inside the United States. Rule 902(c) defines "directed selling efforts" to include "any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered." *Id.* § 230.902(c). Through the offshore transaction requirement, offers and sales must involve only prospective investors physically outside the United States. The directed selling efforts requirement, in turn, restricts preliminary efforts prior to actual offers and sales from occurring within the United States. Rule 902(c) defines "directed selling efforts" to exclude specified tombstone advertisements as well as information U.S. or foreign law requires sellers to publish. *Id.* § 230.902(c)(3).

suers.[26] Those categories represent a policy choice based on two factors: (a) the type of security issued through Regulation S and, less importantly, (b) the Exchange Act reporting status of the issuer in the United States.[27]

Rule 903(b)(2) of the Securities Act establishes the criteria for the first category of transactions, termed "Category 2" transactions, through which U.S. issuers and their distributors may avoid section 5's registration requirements.[28] Under this rule, U.S. issuers may engage in a Regulation S offering so long as the issuers are Exchange Act–reporting companies and offer only debt securities, among other requirements.[29] Rule 903(b)(2) presents the SEC's only acknowledgment within Regulation S for domestic issuers that the market may already have detailed information on Exchange Act–reporting companies and that less regulation is thus necessary.[30] The acknowledgement, however, is limited to the extent that Rule 903(b)(2) explicitly restricts itself to debt securities.[31]

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26. Regulation S sets forth a category available to foreign issuers (designated "Category 1" transactions) where either no substantial U.S. market interest exists in the class of securities being offered or the securities are sold in an "overseas directed offering," including offerings to a single country other than the United States. *Id.* § 230.903(b)(1). In addition, domestic issuers of non-convertible debt securities directed to a single foreign country are eligible for Category 1. *Id.* § 230.903(b)(1)(ii)(B). Issuers of securities offered and sold only to employees of the issuer or an affiliate of the issuer pursuant to an employee benefit plan established and administered under the law of a foreign country are also eligible for Category 1, among other issuers. *Id.* § 230.903(b)(1)(iv).

27. *See supra* note 6 (describing the disclosure requirements placed on Exchange Act–reporting companies).

28. *See* 17 C.F.R. § 230.903(b)(2). Rule 902(d) defines a "distributor" to mean "any underwriter, dealer, or other person who participates, pursuant to a contractual arrangement, in the distribution of the securities offered or sold in reliance on this Regulation S . . . ." *Id.* § 230.902(d). Regulation S offerings under Category 2 must also comply with the two basic offshore offering and directed selling efforts requirements. *See supra* note 25.

29. *See* 17 C.F.R. § 230.903(b)(2). For a discussion of other prerequisites for Category 2 issuers, see *supra* note 25.

30. In contrast, in proposing the original Regulation S in 1988, the SEC stated that:

> The third proposition [behind the Regulation S safe harbors] is that periodic reporting under the Exchange Act can be relied upon for the protection of investors once the marketing effort has been completed. After the foreign distribution has been completed and the marketing efforts have terminated, routine secondary trading may begin as a matter of course. The periodic reporting requirements of the Exchange Act would protect investors in the U.S. market by assuring that information concerning the issuer would be available.

Proposed Offshore Offers & Sales, *supra* note 2, at 22,665.

31. The SEC, moreover, has made clear that debt securities convertible into equity are considered the same as equity securities. *See* Offshore Offers & Sales, *supra* note 10, at 9634 (citing Rule 405 of Regulation C under the Securities Act that "defines the term 'equity secu-

U.S. issuers and their distributors seeking to take advantage of Category 2 transactions through an issue of debt securities are subject to a "distribution compliance period" of forty days.[32] Prior to the expiration of the distribution compliance period, issuers and distributors must ensure that "no offers or sales are made to a U.S. person or for the account or benefit of a U.S. person (other than a distributor)."[33] Issuers and distributors must also implement "offering restrictions" prior to the expiration of the distribution compliance period. Rule 902(g) of the Securities Act, in turn, defines the offering restrictions to require, among other things, that distributors in the offering agree, in writing, that all offers and sales of the securities prior to the expiration of the distribution compliance period are made through a registered offering, through an exemption from registration, or in accordance with Rules 903 or 904 of the Securities Act.[34]

The second class of exempt transactions available to U.S. issuers under Regulation S, termed "Category 3" transactions, is set forth in Rule 903(b)(3) of the Securities Act.[35] Unlike with Category 2 trans-

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rity' to include stock, securities convertible or exchangeable into stock, warrants, options, rights to purchase stock, and other types of equity-related securities").

32. 17 C.F.R. § 230.903(b)(3)(ii)(A). In the original Regulation S, the distribution compliance period was referred to as the "restricted period." *See* Original Regulation S, 17 C.F.R. § 903(c)(2) (1990).

33. 17 C.F.R. § 230.903(b)(2)(i).

34. *See id.* § 230.902(g). Distributors must also agree in writing that for offers and sales of a domestic issuer's equity securities, they will not engage in hedging transactions prior to the expiration of the distribution compliance period unless in compliance with the Securities Act. *See id.* § 230.902(g)(1)(ii). In addition, purchasers of a Category 3 Regulation S offering (including all domestic issuers of equity securities) must agree "not to engage in hedging transactions with regard to such securities unless in compliance with the [Securities] Act." *Id.* § 230.903(b)(3)(iii)(B)(2); *see also* Jon B. Jordan, *Regulation S and Offshore Capital: Will the New Amendments Rid the Safe Harbor of Pirates?*, 19 NW. J. INT'L L. & BUS. 58, 115 (1998) ("[The SEC] did not explicitly provide in the regulation what, if any, hedging transactions are prohibited under Regulation S. There is also no framework for when hedging transactions can take place in 'compliance with the Act' as provided for in the new anti-hedging provisions under Category Three.") (citations omitted).

The offering restrictions also require that:

> All offering materials and documents (other than press releases) used in connection with offers and sales of the securities prior to the expiration of the distribution compliance period . . . shall include statements to the effect that the securities have not been registered under the Act and may not be offered or sold in the United States or to U.S. persons (other than distributors) unless the securities are registered under the Act, or an exemption from the registration requirements of the Act is available. For offers and sales of equity securities of domestic issuers, such offering materials and documents also must state that hedging transactions involving those securities may not be conducted unless in compliance with the Act.

17 C.F.R. § 230.902(g)(2).

35. 17 C.F.R. § 230.903(b)(3).

actions, all domestic U.S. issuers may qualify under Rule 903(b)(3) for an exemption from section 5's registration requirements, regardless of whether a company meets the Exchange Act–reporting company requirements.[36] Also, where Category 2 transactions only encompass debt securities, Category 3 transactions may include both debt and equity securities.[37]

As with Category 2 offerings, issuers and distributors in a Category 3 offering must comply with offering restrictions as set forth in Rule 902(g).[38] To limit further the possibility of resales into the United States, Rule 903(b)(3)(iii) imposes a distribution compliance period of one year on Category 3 transactions.[39] Prior to the expiration of the one-year distribution compliance period for a Category 3 offering, issuers and distributors are also subject to a number of transactional restrictions. For example, Rule 903(b)(3) includes a requirement that purchasers certify that they are not a U.S. person and agree to resell the securities only in accordance with Regulation S, in compliance with section 5's registration requirements, or through another exemption from registration (the "certification" requirement).[40] Issuers are further required to place a legend on issued securities indicating that the securities were sold through Regulation S and are unregistered (the "legending" requirement).[41] Issuers are also required to refuse to register any transfer of the securities not made through a registered offering, an exemption from registration, or under the terms of Regulation S (the "stop-transfer" requirement).[42]

Significantly, domestic Exchange Act–reporting issuers offering equity securities confronted fewer restrictions prior to the SEC's 1998 reforms. In comparison to the present one-year distribution compliance period, domestic reporting issuers that sought to sell equity securities abroad faced only a forty-day restricted period before the reforms.[43] Similarly, domestic reporting issuers offering equity prior to

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36. Rule 903(b)(3) states that its exemption provisions apply "to securities that are not eligible for Category 1 or 2." *Id*.

37. Issuers seeking to conduct a Category 3 transaction must meet the two basic Regulation S requirements. *See supra* note 25.

38. *See supra* note 34 and accompanying text (describing the offering restrictions under Rule 902(g) of the Securities Act). Regulation S offerings under Category 3 must also comply with the two basic offshore offering and directed selling efforts requirements. *See supra* note 25.

39. *See* 17 C.F.R. § 230.903(b)(3)(iii).

40. *See id.* § 230.903(b)(3)(iii)(1),(2).

41. *See id*. § 230.903(b)(3)(iii)(B)(3).

42. *See id*. § 230.903(b)(3)(iii)(B)(4).

43. *See* Original Regulation S, 17 C.F.R. § 902(c)(2) (1990).

the 1998 reforms were not required to meet the same rigid certification, legending, and stop-transfer requirements that apply to all domestic issuers under the present Regulation S. By removing any distinction among Exchange Act–reporting and nonreporting companies issuing equity, the 1998 reforms increased the transactional cost to Exchange Act–reporting companies desiring to raise capital abroad.[44] Commentators have argued that the legending and stop-transfer requirements of Regulation S make it difficult for U.S. issuers to get their Regulation S securities listed on a foreign exchange.[45] Moreover, Rule 905, promulgated as part of the 1998 reforms, makes clear that foreign investors that purchase Regulation S securities, even through secondary market transactions abroad, receive "restricted securities" that may be subsequently resold into the United States only through registration with the SEC or an exemption from registration.[46]

The need for greater regulation of Exchange Act–reporting issuers, however, is unclear. Exchange Act–reporting issuers already must periodically disclose to the SEC and the U.S. securities markets a wide array of information useful to investors.[47] Compared with nonreporting issuers, U.S. investors are at less of an informational disad-

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44. The SEC has argued that, for all types of issuers and securities issued, a risk exists that "an offering could be made at a discount to purchasers offshore who may engage in an illegal distribution back into the United States." Offshore Offers & Sales, *supra* note 10, at 9634. *But see supra* note 30 (quoting from the SEC's earlier position in favor of separate treatment for Exchange Act–reporting issuers).

45. An example of this type of argument can be found in a memorandum discussing the sales of convertible securities of U.S. reporting companies under Regulation S:

> Issuers and investment banks are concerned that if U.S. reporting companies are required to issue convertible securities outside the United States in the form of physical definitive certificates, it would be a serious impediment to the ability of U.S. issuers and other distribution participants to effect offerings of convertible securities in reliance on Regulation S because non-U.S. investors strongly favor holding securities through book-entry systems and will not want to bear the costs, administrative burden and added settlement risk of being required to deliver physical securities and certifications of compliance upon each transfer.

Alan L. Beller, *Memorandum from Cravath, Swaine & Moore Regarding Sales of Convertible Securities of U.S. Reporting Companies Under Regulation S (August 24, 1998) Re: Sales of Convertible Securities of U.S. Reporting Companies Under Regulation S*, 1085 PLI/CORP. 177, 180-81 (1998) (on file with the *Duke Law Journal*).

In response, the SEC simply states, "It is possible that some [foreign] markets can accommodate such securities or may adapt to accommodate them in the future." Offshore Offers & Sales, *supra* note 10, at 9637.

46. *See* 17 C.F.R. § 230.905; *see also supra* notes 11-13 and accompanying text (describing Rule 144's safe harbor for the resale of restricted securities).

47. *See supra* note 6 (describing the periodic disclosure requirements placed on Exchange Act–reporting issuers).

vantage with an Exchange Act–reporting issuer.[48] Furthermore, in November 1996 the SEC increased the disclosure requirements for Exchange Act–reporting issuers conducting a Regulation S offering (the "1996 reporting reform").[49] Prior to the 1996 reporting reform, the SEC did not specifically require issuers to disclose information on Regulation S offerings. Post–reporting reform, the SEC requires reporting issuers to reveal all equity-related Regulation S offerings within fifteen days of the offering under Item 9 of Form 8-K.[50] Given the information that Exchange Act–reporting issuers already provide investors, this Article assesses whether the SEC's 1998 reforms to Regulation S address any substantial risk to U.S. investors.[51]

48. *See supra* note 30 (quoting the SEC's original assumption that the securities market has information available on Exchange Act–reporting issuers). On the other hand, evidence exists that less than one thousand of the more than ten thousand Exchange Act–reporting companies have at least one investment analyst actively following the company. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 41 (1st ed. 1991) (citing REPORT OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SECS. & EXCH. COMM'N xviii & 40-42 (1977)).

As a result, the market may have good information for only a subset of the larger market capitalization Exchange Act–reporting issuers. Rather than focus on Exchange Act–reporting issuers, therefore, regulators may wish to define a subset of the well-followed issuers. For example, the SEC's "Aircraft Carrier" release proposes applying relaxed registration provisions for "Form B" issuers. Form B issuers in turn are those companies with at least a $75 million aggregate market capitalization and an average daily trading volume above $1 million, among other requirements. *See* The Regulation of Securities Offerings, Exchange Act Release No. 33-7606A, 63 Fed. Reg. 67,174, at 67,185 (Dec. 4, 1998).

49. The Regulation S equity reporting requirement became effective on November 18, 1996. *See* Periodic Reporting of Unregistered Equity Sales, Exchange Act Release No. 34-37801, 61 Fed. Reg. 54,506, at 54,506 (Oct. 18, 1996). According to SEC Chairman Arthur Levitt, after the reforms, "[t]he market will thus have an opportunity to react to such offerings before the restrictions against resale in the US expire." Registration of Securities: SEC Tightens Reg S, Other Rules for Unregistered Equity Securities Sales, 28 Sec. Reg. & L. Rep. (BNA) 1239 (Oct. 11, 1996).

50. *See* Form 8-K, Original Item 9, Exchange Act Release No. 4961-Y, 1953 SEC LEXIS 34, at *14 (Nov. 12, 1953); Periodic Reporting of Unregistered Equity Sales, Exchange Act Release No. 34-37801, 61 Fed. Reg. 54,506, at 54,507 (Oct. 18, 1996). Item 9 of Form 8-K requires issuers of equity Regulation S securities to report the information mandated under Item 702 of Regulation S-B, including the offering date, the amount of securities, the total offering price, and the principal underwriters among other information. *See* Form 8-K, Original Item 9, Exchange Act Release No. 4961-Y, 1953 SEC LEXIS 34, at *14 (Nov. 12, 1953).

After January 1, 1999, however, issuers could delay until their next normally scheduled periodic disclosure under Form 10-K or 10-Q to disclose information on a Regulation S offering. A delay of up to one-quarter year, therefore, is now possible before the market learns of a Regulation S offering. *See* Offshore Offers & Sales, *supra* note 10, at 9638.

51. The SEC itself recognizes that smaller "microcap" companies may pose a greater risk of Regulation S abuse. *See* Offshore Offers & Sales, *supra* note 10, at 9632 ("Regulation S has been used as a means of perpetrating fraudulent and manipulative schemes, especially schemes involving the securities of thinly capitalized or 'microcap' companies.").

II. THE REAL DANGER OF REGULATION S

Regulation S provides issuers with a means to conduct an offering of securities outside the U.S. regulatory regime while still enjoying the possibility that the securities may eventually trade within the U.S. capital markets.[52] For example, after a one-year holding period pursuant to Rule 144, most foreign investors are able to resell their unregistered securities freely into the United States.[53] To the extent that the only liquid secondary market for most domestic issuers is located within the United States, foreign investors seeking to resell will do so into the United States.

With resales of unregistered securities into the United States come several purported harms that may afflict U.S. investors—harms that the SEC and others have argued support the present limited scope of the Regulation S exemption and perhaps justify further reducing the ability of U.S. issuers to conduct offerings outside the U.S. regulatory regime.[54] In particular, commentators have focused on the large discount at which Regulation S offerings are typically sold relative to the U.S. secondary market price. Foreign investors who are able to engage in resales rapidly back into the United States, the argument goes, may capture the benefit of this large discount at the expense of U.S. investors.[55] This part analyzes the composition of the Regulation S offering discount and makes the argument that neither a large discount nor resales into the United States of unregistered securities necessarily translates into additional undiversifiable risks for U.S. investors.

Whether U.S. investors are in fact harmed is contingent upon three key factors: (1) the informational advantage that managers of the issuer enjoy over the U.S. secondary market; (2) the ability of the

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52. The Regulation S loophole is limited to the extent that issuers of Regulation S securities must still satisfy other aspects of the U.S. securities regime. For example, to the extent that the issuer is listed on a national securities exchange or satisfies minimum net asset and number of shareholder requirements, the issuer is obligated to comply with various periodic information filing requirements with the SEC. *See supra* note 6 (detailing the Exchange Act–reporting requirements).

53. *See* 17 C.F.R. § 230.144(d) (1999); *see also supra* note 13 (describing additional conditions required to meet the Rule 144 safe harbor).

54. *See* Problematic Practices Release, *supra* note 8, *passim* (describing the harms U.S. investors face from Regulation S).

55. *See id.* at 35,664; *see also* Futterman, *supra* note 8, at 849-51 (providing an example of foreign investors using short sales to quickly shift the economic risk of ownership into the United States for securities initially purchased at a large discount).

U.S. secondary market to adjust to the news of a Regulation S offering with accuracy and in a timely manner; and (3) the incentive of managers to engage in opportunistic behavior. This part discusses the importance of these factors in the range of possible situations in which an offshore offering may occur.

To facilitate the discussion, this Article employs the following hypothetical. Consider Texon, Inc., an oil refinery company located in Texas. Texon is publicly traded on the New York Stock Exchange and has a pre-offering secondary market price of $100 per share. All pre-offering shareholders of Texon are located inside the United States. There are one million shares of Texon outstanding, giving Texon a market capitalization of $100 million. Managers, nevertheless, have nonpublic information that leads them to believe that Texon should be valued at $70 per share. For purposes of the hypothetical, call $70 per share the "fundamental value" of Texon, giving Texon a total fundamental value of $70 million. Relative to the fundamental value, therefore, the secondary market overvalues Texon's common stock. Texon is planning a Regulation S offering to foreign investors of an additional one million shares. For simplicity, assume that the issuer plans to keep the offering proceeds in an interest-bearing bank account indefinitely.[56] Given this assumption, the total fundamental value of Texon will increase by exactly the amount of the offering proceeds.[57]

This Article explores two possible situations: (a) where managers act in the best interests of their pre-offering shareholders and (b) where managers act opportunistically, using Regulation S to engage in self-dealing or to raise suboptimal levels of capital.

A. *Managers Acting in the Best Interests of Pre-Offering Shareholders*

Managers often will act in the best interests of their company and the company's shareholders. The incentives of managers and their shareholders are aligned through a combination of ethical considera-

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56. More technically, assume that the interest rate just equals the discount rate for the time value of money. The assumption that the issuer simply plans to put the offering proceeds into a bank account will later be relaxed. *See* discussion *infra* Part II.B.2.

57. The analysis assumes for simplicity that offering expenses equal zero. The per share fundamental value, in turn, will depend on both the increase in the total fundamental value of Texon and the increase in the number of outstanding common shares.

tions,[58] reputational concerns,[59] state law fiduciary duties,[60] stock options,[61] and market forces.[62] Managers with such incentives will seek to maximize the value to pre-offering shareholders from the issuance of new securities, seeking systematically to sell into markets that overvalue the securities.[63] Even where managers act in the best interests of pre-offering shareholders and these shareholders are all U.S. residents, a Regulation S offering may still impact negatively on certain segments of U.S. investors. In particular, where issuers seek to sell overvalued securities into the U.S. markets indirectly through a Regulation S offering, U.S. *purchasers* of the securities may suffer harm.[64] Crucial to the harm which U.S. investors face is the amount of overvaluation in the U.S. secondary market and the market's ability to react to news of a Regulation S offering to correct for this overvaluation.

This section examines the possible harm to U.S. investors from overvaluation-driven Regulation S offerings through four scenarios:

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58. Many business schools, for example, require students to enroll in business ethics courses. *See* Richard Donkin, *Business Ethics: The Rights and Wrongs*, FIN. TIMES, Oct. 9, 1997, at 4.

59. Managers, for example, may seek to develop a pro-shareholder reputation to aid them in obtaining a better job or a promotion. *See* Shuichi Senbongi & Joseph E. Harrington, Jr., *Managerial Reputation and the Competitiveness of an Industry*, 13 INT'L J. OF INDUS. ORG. 95, 108-09 (1995) (predicting that managers produce more quantity than would maximize profits in imperfectly competitive industries as a means of increasing their reputation in the managerial labor market).

60. *See, e.g.*, REVISED MODEL BUS. CORP. ACT § 8.30(a) (1991) ("A director shall discharge his duties as a director, including his duties as a member of a committee . . . in a manner he reasonably believes to be in the best interests of the corporation."); *see also* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1045 (1991) (providing a law-and-economics analysis of the fiduciary duties).

61. *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 65 (citing a wave of organizational innovation toward "active investors"); Michael C. Jensen & Jerold L. Zimmerman, *Management Compensation and the Managerial Labor Market*, 7 J. ACCT. & ECON. 3, 4-6 (1985) (discussing the effect of aligning shareholders' and managers' interests).

62. For example, the takeover market may align the incentives of managers with shareholders. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 705 (1982) ("Corporate control transactions can reduce agency costs if better managers obtain control of the firm's assets or if they alter the incentive structure facing existing managers. Corporate takeovers, and subsequent changes in management, increase the wealth of investors.").

63. *See* Myers & Majluf, *supra* note 17, *passim*.

64. Even when purchasing overvalued securities, U.S. purchasers are not necessarily harmed. Where all the pre-offering shareholders of the issuer purchase overvalued Regulation S securities in the same proportion as their pre-offering ownership, the shareholders simply transfer value to themselves. In such a situation, the pre-offering shareholders may still suffer a reduction in value from the transaction costs of the offering, however.

(1) where resales of Regulation S securities do not take place into the United States; (2) where resales occur and the market fails to react to news of the Regulation S offering; (3) where resales occur and the market reacts perfectly to news of the Regulation S offering; and (4) where resales occur and the market reacts imperfectly to such news.

1. *No Resales into the United States.* Consider first the situation where securities sold abroad are never resold into the United States. Texon common stock, for instance, after being sold through Regulation S, may come to rest in Asia and never physically return to the United States. Managers of Texon who expect no resales into the United States must first decide upon a price at which to offer their securities. In particular, managers that seek to maximize the value for pre-offering shareholders will have an incentive to issue Texon's common stock at a price above the company's fundamental value.[65] For example, where Texon is able to sell one million shares in its Regulation S offering at $100 per share to foreign investors, equal to the pre-offering U.S. secondary market price, the company will take in $100 million of additional capital. Texon will then have a post-offering total fundamental value of $170 million,[66] giving Texon shareholders a per share fundamental value of $85.[67]

In this situation, U.S. investors as a group are directly benefited from the Regulation S offering. Where the pre-offering shareholders of Texon (all U.S. investors) used to hold securities with a fundamental value of $70, they now own securities with a value of $85 per share. In contrast, foreign investors that purchased Texon securities at over-inflated prices from Texon are systematically harmed, overpaying $15 per share on average for their investment.[68]

Despite the direct benefit, U.S. investors may claim several possible harms. First, once the U.S. market learns of the offering, the market price of Texon's stock inside the United States will drop in re-

65. *See* Myers & Majluf, *supra* note 17, at 207.

66. Pre-offering, Texon had a fundamental value of $70 million, despite its U.S. secondary market price of $100 million.

67. Post-offering, two million common shares of Texon will be outstanding. Given a post-offering total fundamental value of $170 million, the per share value will equal $85.

68. The observation that U.S. investors and, in particular, pre-offering shareholders of the issuer are benefited when the issuer sells overvalued securities to foreign investors leads to the conclusion that U.S. investors gain as U.S. companies actively defraud foreign investors. Indirectly, nevertheless, U.S. investors may face harm from such activity. In addition to the harms discussed in the text, U.S. investors may face harm to the extent that other countries retaliate through lax regulations that allow foreign companies to export fraud into the United States.

sponse. Given the incentive of managers to sell securities when the market overvalues the securities,[69] investors will take news of an offering as a signal that managers believe the market is overvalued.[70] Such a signal, in turn, will result in a drop in the secondary market price. Where the stock market suffers from no systematic biases, the market reaction on average will correctly value the degree of overvaluation, and the market price will tend toward $85 per share.[71]

U.S. shareholders in Texon may then argue that they suffer harm from the drop in the U.S. secondary market price resulting from disclosure of the offering. Nevertheless, the harm that U.S. investors bear is no different from the harm resulting from any other disclosure of negative information about the company.[72] Any release of negative information will result in a stock price decline that reduces the wealth of pre-disclosure shareholders in the company. To argue against allowing offshore offerings to protect solely against disclosure-related harms to investors is equivalent to arguing for a delay in providing the market with valuable information. Although negative disclosures may harm those U.S. investors that own a particular security, such disclosures equally benefit other U.S. investors seeking to purchase the security. Thus, to the extent that foreign investors do not resell into the United States, U.S. investors as a group are not harmed. Finally, disclosure of information on the company results in stock market prices that reflect the true assessment of the relative values of different investments in society.[73]

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69. *See supra* note 17 and accompanying text.

70. News of an offering, of course, may signal other information to investors. On average, however, the market will correctly adjust the market price for the possibility that managers believe the market is overvalued. *See* Nord Pacific Ltd., *Form 8-K* (Dec. 24, 1997), *available at* http://www.freeedgar.com (on file with the *Duke Law Journal*).

71. *See* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2535–39 & nn.75–78 (1997) (summarizing evidence of unbiased pricing in the securities markets).

72. Significantly, harm from the informational signal investors receive from the fact of Regulation S offering itself impacts all shares of the same class of the issuer's common stock equally, whether the share is traceable to the Regulation S offering itself or to a prior U.S.-targeted offering of the issuer. Consider two shares of common stock of Texon, Inc. One share was sold through Texon's IPO in the United States in 1980. The other share was sold through a Regulation S offering to a foreign investor in 1998. Whether a U.S. investor purchases the common stock carrying an IPO or Regulation S pedigree, shares of the same class of common stock will provide the same dividend, voting, and liquidation rights, among others. Therefore, negative information that reduces the market's assessment of Texon will diminish the value of all shares of common stock equally regardless of how the shares initially entered the market.

73. As a result, among companies competing with one another to raise additional investment, capital resources will shift to their highest value use in society. *See, e.g.*, John F. Barry, III, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1315-17 (1981)

Second, U.S. investors may be harmed to the extent that investors in the rest of the world start viewing the group of all U.S. companies as systematically issuing overvalued securities. Foreign investors with such an expectation will refuse to purchase U.S. securities unless granted a large discount. Thus, the scenario's assumption that foreign investors would pay $100 per share for Texon's securities is unrealistic; rational foreign investors will discount for the risk of purchasing overvalued securities and pay, on average, only the pre-offering fundamental value of $70.[74] Moreover, to the extent that foreign investors are unable to distinguish between different issuers, they will demand a similar discount of all U.S. issuers, raising the cost of capital for even those U.S. companies without an overvaluation motive in seeking to raise funds overseas.[75]

Significantly, Regulation S affords U.S. companies no protection against the discount that foreign investors may demand of issuers to compensate for the risk of purchasing overvalued securities.[76] Individual U.S. companies nevertheless may attempt to signal the value of their securities through a variety of mechanisms. For instance, a U.S. company could voluntarily register its offering under U.S. securities laws. In the alternative, U.S. issuers could register under another country's regime to signal the value of their securities to foreign investors.[77] To the extent that an individual U.S. company internalizes

(discussing the "continual redirection of capital from less promising to more promising pursuits"). Professor Lynn Stout, in contrast, argues that many companies do not turn to the equity capital markets to raise money and that alternative sources—including bank financing—do not rely on equity market price signals. Stout also contends that the price issuers receive is more a function of the negotiations between the issuers and their underwriters than the contemporary secondary market price. *See* Lynn Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 642-57 (1988).

74. Note that as a percentage of the pre-offering price, foreign investors are receiving a large discount. However, foreign investors that do not resell into the United States ahead of the market reaction do not benefit from this discount.

75. A lemons problem may then result as companies with non-overvalued securities choose not to issue securities rather than endure a discount from investors that are unable to distinguish among different companies. The average level of overvaluation in offered securities will then rise, resulting in an even greater required discount for investors and driving even more non-overvalued companies out of the securities offering market. *See* George A. Akerloff, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488-500 (1970) (describing the lemons problem).

76. Indeed, the premise of Regulation S is to free U.S. issuers from the registration requirements of the Securities Act so long as the issuers offer and sell securities only outside the United States. *See supra* notes 22-24 and accompanying text (discussing the territorial nature of Regulation S).

77. U.S. companies could also employ a financial intermediary with a good reputation to certify the value of the companies' securities. *See* Stephen Choi, *Market Lessons for Gatekeep-*

the full benefit from distinguishing itself in this manner in the form of a higher offering price, it will have full incentives to do so.[78]

2. *Resales into the United States Pre–Market Reaction.* The second possible situation involves the resale of Regulation S securities initially sold to foreign investors back into the United States. In particular, consider the scenario where foreign investors are able to resell securities into the United States prior to any secondary market reaction to the news of the Regulation S offering. As a result, foreign investors will, on average, receive the pre-offering market price for their securities from U.S. purchasers.[79]

As with the previous situation of no resales into the United States, managers seeking to maximize the value of pre-offering shareholders will conduct a Regulation S offering only when they receive an offering price *at least* equal to the company's fundamental value. Selling at below the fundamental value results in the dilution of all pre-offering shareholders, including the management's own holdings. Managers, therefore, will attempt to obtain as great an overvalued price as possible from the offering. The greater the price managers are able to obtain from the foreign investors, the more wealth managers are able to transfer to the issuer's pre-offering shareholders.

In the Texon example, foreign investors will expect to resell into the United States at $100 per share, the pre-offering market price. Absent any motivation on the part of managers to benefit foreign investors, managers of Texon will negotiate with foreign investors for a price as close to $100 as possible. Put another way, given Texon's fundamental value of $70 per share, the amount of overvaluation in the U.S. secondary market is equal to $30 per share (the "overvalua-

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ers, 92 NW. U. L. REV. 916, 927-33 (1998); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 89-91 (1986).

78. For example, consider a market where foreign investors expect that all U.S. issuers on average overstate the value of their securities by 50% and where the investors are unable to distinguish among issuers. In such a market, investors will demand a 50% discount, even from issuers that do not engage in any overstatement of value. To the extent that such truthful issuers are able, however, to signal credibly their value, they are able to sell their securities without any discount. Some commentators, nevertheless, have argued that issuers may ignore the benefit accurate securities pricing may have for external third parties. Professor Merritt Fox, for example, has argued that labor benefits from accurate securities prices. *See* Fox, *supra* note 71, at 2562-69.

79. The exact price foreign investors receive will depend on other exogenous effects on the market that occur prior to resales. To the extent that no systematic bias exists on these exogenous effects, foreign investors on average will receive the pre-offering market price plus a risk-adjusted return for the amount of time between the offering and the commencement of the resales.

tion surplus").[80] Managers will want to capture as much of the $30 overvaluation surplus as possible through a *low* offering discount for foreign investors.

The magnitude of the offering discount, therefore, depends on the relative bargaining strengths of the issuer and foreign investors. Where foreign investors enjoy a stronger bargaining position, the issuer will offer the securities at a greater discount. Consider the situation where Texon conducts its offering at $75 per share to foreign investors who then immediately resell into the U.S. at $100 per share. Texon receives only $5 per share of the overvaluation surplus. On the other hand, where the issuer is in a more favorable bargaining position, the issuer will sell to foreign investors at a reduced discount. For instance, Texon may sell securities at $95 per share to foreign investors that resell into the U.S. at $100 per share. Texon then receives $25 per share of the overvaluation surplus and foreign investors receive $5 per share of the surplus. In either case, however, U.S. purchasers of Texon securities resold through Regulation S overpay by $30 per share.[81] Regardless of whether the issuer or foreign investors enjoy stronger bargaining positions, U.S. purchasers are harmed through the indirect sales of overvalued securities into the United States.

The key determinants of the harm that U.S. investors face from a Regulation S offering involving resales into the United States are the informational advantage managers have over the U.S. secondary market and the ability of the U.S. secondary market to react to news of the Regulation S offering. First, the degree of informational advantage that managers of the issuer enjoy over the secondary market directly affects the size of the overvaluation surplus. Where managers possess confidential nonpublic information, there is a heightened probability that the market's estimation of the company's value, represented through the secondary market price, is different from the fundamental value. The magnitude of the difference is likely to be greater as well. Of course, the market may also mistakenly under-

80. In this situation, the overvaluation surplus is equal to the $100 secondary market price minus the $70 fundamental value.

81. In fact, all purchasers of Texon's securities overpay by the amount of the overvaluation surplus whether they purchase securities originally sold through Regulation S or from an earlier U.S.-based offering. U.S. investors, as a group, however, are harmed only to the extent that some of the overvaluation surplus is transferred not to another U.S. investor but rather outside the United States. The magnitude of the harm to U.S. investors as a group, therefore, depends on the number of Regulation S securities resold into the United States.

value the company's securities to a greater degree when managers enjoy a larger informational advantage.[82] However, managers may choose systematically to forego issuing securities in such situations, selling only when the market overvalues the securities.[83] As a result, the frequency and magnitude of overvalued offerings will increase with the extent of the informational advantage managers have over the market.

Second, the ability of the U.S. markets to react both quickly and accurately to news of a Regulation S offering will affect the amount of harm U.S. investors face from the resale of overvalued Regulation S securities into the United States. U.S. investors face the greatest risk of purchasing overvalued securities resold through Regulation S where the market reacts only slowly and inaccurately to news of a Regulation S offering. In the extreme, where the market fails to react to the Regulation S offering prior to resales into the United States, foreign investors and the issuer may obtain the full value of the overvaluation surplus as part of the offering proceeds to the detriment of U.S. purchasers.

Short sales, in particular, may expose U.S. investors to the risk of resales of overvalued securities into the United States. A foreign investor, for example, may purchase securities from Texon at $90 per share (leaving the pre-offering shareholders of Texon with a gain of $20 per share above the pre-offering fundamental value of $70 per share). The foreign investor may then execute short sales of securities within the United States, borrowing securities in Texon from a U.S. broker and then selling the borrowed securities at $100 per share into the United States. After the expiration of the Regulation S restricted period, the foreign investor may then use its offshore securities in Texon to "cover" the investor's initial loan of securities from the U.S. broker. Through short sales, a foreign investor may immediately lock-in the $10 per share discount it received from the issuer, and the issuer indirectly may capture value from the secondary market's overvaluation of the issuer's securities for the pre-offering shareholders.

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82. For example, the U.S. secondary market price for Texon may equal $50 per share. Where Texon has a fundamental value of $70 per share, issuing securities at $50 will dilute the interest of pre-offering shareholders to the benefit of purchasing investors.

83. *See* Robert A. Korajczyk et al., *The Effect of Information Releases on the Pricing and Timing of Equity Issues*, 4 REV. FIN. STUD. 685, 688-92 (1992) (discussing the incentive of managers to delay an equity offering prior to the disclosure of positive information but not prior to the disclosure of negative information).

Short sales, therefore, may provide foreign investors an easy means of reselling overvalued securities into the United States prior to any secondary market reaction to news of the offering, potentially reducing the effective Regulation S restricted period down to zero calendar time. The SEC, nevertheless, started taking a hard line against foreign investors engaging in short sales of Regulation S securities in 1995.[84] The 1998 reforms further clarified the SEC's prohibition against short sales and other hedging transactions that have the effect of shifting the economic risk of ownership into the United States prior to the expiration of any limitations on resales into the United States.[85]

3. *Resales into the United States Post–Market Reaction—Accurate Response.* The third situation involves a Regulation S offering where foreign investors engage in resales back into the United States after the U.S. secondary market reacts to news of the offering. Assume further that the U.S. secondary market reaction is perfectly accurate, discounting fully for the negative information signaled through news of the offering.

U.S. markets may receive news on a Regulation S offering in one of several ways. First, the issuer may directly notify the market of the offering. Issuers, for instance, may voluntarily distribute a press release on the offering.[86] In cases where the offering signals positive in-

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84. *See* Problematic Practices Release, *supra* note 8, at 35,663:

> Since the adoption of Regulation S, it has come to the Commission's attention that some market participants are conducting placements of securities purportedly offshore under Regulation S under circumstances that indicate that such securities are in essence being placed offshore temporarily to evade registration requirements with the result that the incidence of ownership of the securities never leaves the U.S. market, or that a substantial portion of the economic risk relating thereto is left in or is returned to the U.S. market during the restricted period, or that the transaction is such that there was no reasonable expectation that the securities could be viewed as actually coming to rest abroad. These transactions are the types of activities that run afoul of Preliminary Note 2, would not be covered by the safe harbors and would be found not to be an offer and sale outside the United States for purposes of the general statement under Rule 901.

See also In re GFL Ultra Fund Ltd., Exchange Act Release No. 7423, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,949, at 89,752 (June 18, 1997) (holding that a fund that purchased securities through a Regulation S offering and then immediately engaged in short sales into the United States acted as a statutory underwriter under section 2(11) of the Securities Act for the issuer).

85. *See supra* note 34 (discussing the 1998 reform provisions against hedging transactions).

86. Numerous companies issued a press release related to their Regulation S offering during the pre–reporting reform period. *See, e.g.*, *Intl Thoroughbred Completes Sale of 1.9M Shrs For $5.7M*, DOW JONES NEWS SERV., Dec. 29, 1995; *Preferred Telecom Completes $1.5 Million*

formation about the company, managers and pre-offering shareholders gain from such disclosures. For example, an issuer may engage in a Regulation S offering to raise capital for a shareholder wealth-increasing product development project; investors may consider news of the offering as a credible signal to the market that the product development is moving forward.[87]

Second, the market may learn of a Regulation S offering indirectly through changes in trading volume in the market itself. In the case of issuers followed by several analysts, for example, an increase in trading volume will receive immediate attention. Analysts may then investigate further to determine the source of the increased volume. U.S.-based analysts, for instance, may monitor the level of short sales in a particular issuer's securities. An increase in short sales may spur the analysts to investigate further the source of the short sales, potentially uncovering the identity of foreign investors and the existence of a Regulation S offering as a result. Foreign investors that hope to take advantage of a slowly reacting market, therefore, must sell securities piecemeal into the market. Where several foreign investors own securities, however, they will face a collective action problem in restraining themselves from flooding the U.S. market with their securities. Similarly, financial institutions with multinational offices may learn of a Regulation S offering from resales that occur abroad and convey this information to affiliated analysts monitoring the issuer inside the United States.[88] On the other hand, not all companies enjoy an active analyst following.[89] The absence of analysts

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Regulation S, PR NEWSWIRE, Oct. 30, 1995; *SUGEN Raises Approximately $16.8 Million in a Regulation S Transaction*, BUS. WIRE, Sept. 21, 1995.

87. Of course, only some product development projects benefit shareholders. In other cases, managers may engage in product development projects to increase their power and prestige. *See infra* note 107 (discussing the general agency problem between managers and shareholders).

88. Many financial market intermediaries are now present in a large number of countries. For example, The Goldman Sachs Group, Inc. has 41 offices in 23 countries worldwide. *See Goldman Sachs: About Us—Office Locations*, Goldman Sachs, *at* http://www.gs.com/about/office-locations.html (last visited Oct. 26, 2000) (on file with the *Duke Law Journal*). Information that brokers in a Goldman Sachs office located in Paris learn of U.S. securities issued or traded abroad, therefore, may make its way easily into the U.S. markets through the Goldman Sachs office in New York.

89. Note that evidence exists that less than one thousand of the more than ten thousand Exchange Act–reporting companies have at least one investment analyst actively following the company. *See* COX ET AL., *supra* note 48, at 41 (citing REPORT OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SECS. & EXCH. COMM'N xviii & 40-42 (1977)).

may make it more difficult for the market to respond accurately to the increased trading volume from resales into the United States.[90]

Once the market does receive news of a Regulation S offering, the impact on secondary market prices depends on a number of different factors. The mere fact, for instance, that a company's managers seek to raise capital from the market may suggest that the managers believe that the market presently overvalues the company.[91] Managers who seek to maximize the present shareholders' wealth, including perhaps their own wealth, will attempt to sell securities into the market at an inflated value. Several other motivations, of course, exist for a Regulation S offering. For example, news that a company seeks specifically to raise capital abroad through Regulation S rather than inside the United States may signal that the company intends to expand into overseas business opportunities.[92] The possibility of other motivations, therefore, may result in a noisy signal sent to the market. Nevertheless, to the extent that the market suffers from no systematic biases in how it interprets information, on average the market will correctly determine the degree of overvaluation.[93]

Where the market's response to the Regulation S offering is 100% accurate, neither the issuer nor foreign investors are able to capture any overvaluation surplus from U.S. purchasers. Rational

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90. *See also infra* Part IV.B (discussing the need to distinguish among different types of issuers in Regulation S). Nevertheless, where few analysts follow a particular company, the market typically is thinly traded. For example, companies that trade on the U.S. over-the-counter pink sheets market have few active analysts tracking their securities and a relatively low daily trading volume. *See, e.g.*, 3D HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 23.10 (2d ed. 2000) (providing a description of the pink sheets market). A large influx of securities, therefore, may create a larger percentage increase in the trading volume, prompting even casual market participants to investigate further to determine the cause of the volume increase.

91. Evidence exists that the market reacts negatively to announcements of an equity issue. *See* Paul Asquith & David W. Mullins, Jr., *Equity Issues and Offering Dilution*, 15 J. FIN. ECON. 61, 61 (1986) (investigating the effects on stock prices of seasoned equity offerings); Ronald W. Masulis & Ashok N. Korwar, *Seasoned Equity Offerings: An Empirical Investigation*, 15 J. FIN. ECON. 91, 91 (1986) (examining common stock price adjustments to announcements of underwritten common stock offerings); Wayne H. Mikkelson & M. Megan Partch, *Valuation Effects of Security Offerings and the Issuance Process*, 15 J. FIN. ECON. 31, 31 (1986) (pondering the stock price effects of security offerings on the inferences made by investors).

92. Companies seeking to enter into a new geographical market, for example, may desire to establish shareholder ties with key individuals in those countries. For instance, Nord Pacific Resources Limited sold 600,000 of its common stock to Mineral Resources Development Company Pty, Limited, a corporation wholly owned by the Papua New Guinea government, in late 1997. Nord Pacific planned to use the proceeds of its offering to commence nickel and gold mining projects in Papua New Guinea. *See Nord Pacific Ltd. Form 8-K*, *supra* note 70.

93. The noise in the information signal sent from news of a Regulation S offering increases the variance in the market's overall reaction.

foreign investors will therefore require a discount from the pre-offering secondary market price to compensate for the expected negative secondary market reaction to the offering. Consider the Texon example. After information on the Regulation S offering enters the U.S. market, the secondary market price will drop to $70 per share, the fundamental value of Texon. Foreign investors that resell into the United States will receive no more than $70 per share for their Regulation S securities. As a result, if foreign investors pay a price greater than $70, they transfer value to the pre-offering shareholders of Texon. Rational foreign investors that anticipate the drop in the secondary market price due to the information disclosure of the Regulation S offering will negotiate for a discount to compensate for the drop.[94] Foreign investors may learn about the fundamental value from the issuer's managers as part of their purchase negotiations. Even where foreign investors do not receive any nonpublic information during the offering, they will demand a discount for the average level of overvaluation among offered Regulation S securities.

Where the U.S. secondary market reacts perfectly to news of a Regulation S offering prior to the commencement of Regulation S resales, the wealth effect on U.S. investors is similar to the situation in which Regulation S securities are never resold into the United States. To the extent that managers engage in offerings of overvalued securities to foreign investors, pre-offering U.S. shareholders of the issuer benefit at the expense of foreign investors. Rational foreign investors, therefore, will demand a discount from the pre-offering U.S. secondary market price equal to the entire overvaluation surplus. Discounts for Regulation S offerings where foreign investors expect to resell only after a U.S. secondary market reaction to news of the offering, all other things being equal, will be greater than the discount foreign investors receive when reselling into a market that does not adjust for news of the offering. The mere fact of a large offering discount, however, itself does not result in harm to U.S. investors.[95]

Compared with the situation where no resales take place into the United States, resales present an additional risk of harm to U.S. investors. To the extent that worldwide securities markets are fragmented, resales into the United States may result in an increase in the

94. Foreign investors that fail to receive compensation and thus expect to receive a negative return from the Regulation S investment will simply choose not to invest.

95. Rather, the harm to U.S. investors comes from the disclosure of negative information that the company's secondary market price is greater than the fundamental per share value. *See supra* notes 72-73 and accompanying text.

average trading volume in U.S. markets. With an increase in the supply of securities, some may argue, greater downward pressure may exist on the U.S. secondary market price regardless of any information effect from the offering.[96] Thus, despite Texon's fundamental value of $70, the addition of one million shares offered through Regulation S into the U.S. secondary market may cause the market price to drop below $70 down to $60 per share. Against this possibility, however, is the force of market arbitrage.[97] To the extent that the market price is below $70, large market participants will have a strong incentive to purchase additional securities to receive a gain from the market's undervaluation of Texon's common stock.[98] The possibility of arbitrage, moreover, is tied directly with the size of the market for the issuer's securities. Since analyzing and tracking a company's securities require a fixed expense on the part of financial institutions, the per-share cost of actively monitoring a company's securities is much lower for larger market capitalization issuers.[99]

4. *Resales into the United States Post–Market Reaction—Inaccurate Response.* The fourth situation involves foreign resales of Regulation S securities after the disclosure of information on the offering into the U.S. markets with one important difference from the third situation delineated above: instead of assuming that markets react with perfect accuracy, the Article now assumes that markets

96. *See, e.g.*, Bruce McWilliams, *Money-Go-Round: Higher Still and Higher for the High-Tech Stocks*, DAILY TEL. (London), Feb. 5, 2000, at 16 ("[W]ave[s] of new European technology companies that aim to market their shares through initial public offers. . . . will increase the supply of technology shares and may keep prices from rising. Indeed, if demand is constant and supply increases, then prices must fall.").

97. Put another way, the demand for securities is perfectly elastic. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 345-46 (5th ed. 1996). *But see* Lynn A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475, 484-92 (1997) (arguing that the assumptions behind a perfectly elastic demand curve for stocks are flawed).

98. For example, a financial intermediary that purchases 100,000 shares at $60 stands to gain $1 million once the stock price returns to the fundamental value of $70 per share.

99. On the other hand, some commentators have argued that even financial analysts may not act entirely rationally. *See, e.g.*, Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 643-49 (1996) (arguing that investment professionals may suffer from behavioral irrationalities in their investment decisions). Even where money managers act rationally, they may fail to take advantage of all arbitrage opportunities in the securities market to the extent that their pay and prestige is determined in reference to other money managers, giving them an incentive to herd together in their decisions. *See generally* David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465 (1990) (noting that managers rationally herd their behavior to improve the reputation of their decisionmaking).

react with some degree of inaccuracy. In particular, assume that the U.S. secondary market has no systematic biases and is therefore correct on average.[100] Faced with a number of Regulation S offerings, the market will react on average sufficiently to bring the secondary market price to the issuer's fundamental value. For any given issuer, nevertheless, the market may not adjust to match the post-offering fundamental value. For instance, in the case of Texon's Regulation S offering, foreign investors may expect the market to react to news of the offering with a price of $70, the fundamental value of Texon shares. In any specific case, however, the market may react with a post-disclosure secondary market price of $50 per share, undervaluing the company. In the alternative, the market may react with a price of $90, overvaluing the company.

Given some inaccuracy in how the U.S. secondary market interprets information on a Regulation S offering, whether U.S. purchasers are actually harmed from resales into the United States depends on the informational advantage that foreign investors enjoy over the U.S. secondary market and on the liquidity needs of the foreign investors. Consider the situation where Sophie, a foreign investor based in Belgium, purchases Regulation S securities and then resells into the United States. Where Sophie has no informational advantage over U.S. investors, she will not realize that the market overvalues Texon's shares when it prices the shares at $90; similarly, she will not realize that $50 per share undervalues Texon's shares. Sophie will sell into U.S. markets at both prices—and U.S. investors are thus equally likely to overpay or to underpay for the offshore securities resold into the United States. U.S. investors as a group therefore are not harmed. Individual U.S. investors purchasing a diversified portfolio of Regulation S securities will experience the same return on average as if they purchased each individual security at its true fundamental value.[101]

Consider next the situation where Sophie does enjoy an informational advantage over the U.S. secondary market through confidential information obtained from the issuer. Sophie, in deciding whether to

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100. Absent some irrationality among investors, *see supra* note 99, investors will make their best guess at the value of a security based on the information provided. Although investors may guess too high or too low, no reason exists to suspect that rational investor will systematically either be too high or too low.

101. For example, suppose that Andrew, a U.S. investor, pays $10 per share too much for one issuer's Regulation S securities and $10 too little for another issuer's Regulation S securities. Assuming Andrew buys the same quantity of both issuers' securities, he will end up with the same return as if he paid the fundamental value for each set of securities.

invest in Texon, may ask the issuer for nonpublic information related to the valuation of Texon.[102] Texon is not obligated to furnish such information to Sophie—at least under U.S. law pursuant to Regulation S[103]—but if Texon refuses to supply information voluntarily, Sophie may choose not to invest.[104] Assume Sophie learns that the fundamental value of Texon is $70 per share. Where the U.S. market overreacts to news of the Regulation S offering, setting a new market price of $50 per share, for example, Sophie may choose not to resell. In comparison, where the U.S. market underreacts, setting a market price of $90 per share, Sophie will choose to resell at a profit. On average, therefore, Sophie and other foreign investors benefit at the expense of U.S. purchasers.

The degree to which foreign investors gain depends on the informational advantage foreign investors possess over the U.S. secondary market. Absent any systematic biases within the market, the market will on average be correct in its valuation. Nevertheless, foreign investors with an informational advantage will have some ability to distinguish when the market over- and undervalues the securities. The larger the informational advantage, the more likely that foreign investors will realize that the market price incorrectly values the issuer. Companies, therefore, with a greater degree of information disclosed to the market—including, for instance, Exchange Act–reporting companies—provide foreign investors with a diminished opportunity to transfer value systematically from U.S. investors due to inaccuracies in U.S. market pricing.[105]

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102. The SEC recently reduced the ability of Exchange Act-reporting issuers to provide nonpublic material information to potential Regulation S investors, among other parties. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 34-43154, 2000 WL 1239722 (Aug. 15, 2000).

103. On the other hand, another country's securities regulatory regime may require such disclosure. If Texon, Inc. sell securities into Japan under Regulation S, Japanese securities laws may require additional information disclosure to Japanese investors.

104. *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 676-78, 682-83 (1984) (discussing the incentive of companies to voluntarily disclose information to investors). *But see* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 751-52 (1984) (arguing for a mandatory disclosure regime).

105. As discussed earlier, not all Exchange Act–reporting companies are alike. *See supra* note 48. Although Exchange Act–reporting companies must all disclose the same level of information periodically under the Exchange Act, *see supra* note 6, the number of analysts actively following a company varies widely among the entire group of Exchange Act–reporting companies. Nevertheless, for some subset of Exchange Act–reporting companies, the claim remains true that foreign investors will have a much reduced ability to transfer value away from U.S. investors.

The ability of foreign investors to gain at the expense of an inaccurate market reaction also depends on the liquidity needs of the foreign investors. Where foreign investors require immediate cash for their securities, they will be unable to delay the resale of securities into the United States even where the U.S. secondary market undervalues the securities. In particular, the pressure to resell quickly into the United States is greatest for foreign investors acting as simple conduits for U.S. issuers. Such investors typically have a large percentage of their capital tied into the offering and expect to recover their capital immediately after resales into the United States occur.[106] Delay in resale exposes such conduits to an undiversified risk that the Regulation S securities may drop in value as well as increases the opportunity cost from other more valuable uses for the capital. Investors seeking to act as conduits for U.S. issuers are therefore least able to take advantage of an imperfect market reaction to news of the Regulation S offering.

Thus, only in situations where foreign investors both (a) enjoy an informational advantage over the U.S. secondary market and (b) are able to take advantage of this information by choosing not to sell into the United States where the U.S. market undervalues the issuer's securities may foreign investors gain at the benefit of U.S. investors when the market reacts with some degree of inaccuracy to news of an offshore offering.

B. Managers Acting Opportunistically

Managers seeking to use Regulation S offerings for their own private benefit represent an entirely different class of harm for U.S. investors.[107] Regulation S offerings and resales driven by the over-

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106. In the United States, underwriters in a firm commitment offering serve a similar conduit function for public offerings. In a firm commitment offering, underwriters purchase the securities from the issuer and then attempt to resell the securities into the public market. Because underwriters bear the risk of not selling the securities, the large fee they demand is in part compensation for this risk. *Cf.* Randolph P. Beatty & Ivo Welch, *Issuer Expenses and Legal Liability in Initial Public Offerings*, 39 J.L. & ECON. 545, 556-57 (1996) (reporting that underwriters from a sample of 952 initial public offerings from 1981 to 1984 received a mean 7% discount on the offering as their compensation plus underwriter expenses).

107. Firms where managers hold less than 100% of all the equity may suffer from an agency cost problem. To the extent that managers own only a fraction of the equity, they do not capture the full benefit from actions that increase overall shareholder welfare. Therefore, managers may seek to divert value from the shareholders and to their own individual use; in the alternative, managers may simply choose to slack and not maximize shareholder welfare. *See, e.g.*, Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 288-89 (1980) (recommending the manager have a stake in the success of the organization); Eugene F. Fama

valuation of the issuer's securities in the U.S. secondary market benefit all pre-offering shareholders in addition to foreign investors.[108] Regulation S offerings conducted solely for the benefit of managers, in contrast, transfer value away from pre-offering shareholders and toward the issuer's managers. Offshore securities offerings designed to benefit managers may take one of at least two possible forms: (1) transactions involving sales of discounted securities to entities in which insiders own an equity interest or to block shareholders willing to support opportunistic insiders in return for the discounted securities (collectively termed "insider self-dealing" transactions) and (2) transactions that raise a suboptimal amount of capital for the issuer but nevertheless provide managers benefit ("suboptimal capital investment" transactions).

1. *Insider Self-Dealing Transactions.* Insiders may force a company to sell securities abroad through a Regulation S offering to facilitate discounted sales to themselves or related parties. Insiders may also use a discounted Regulation S offering to transfer value to a particular block shareholder in return for the block shareholder's support of management. Several anecdotal instances of insider self-dealing through Regulation S exist. For example, in 1997 Cheniere Energy, Inc. sold securities through Regulation S to an overseas investor using Investors Administration Services, Ltd. as its placement agent.[109] One of the principals of the placement agent was the brother of the Chairman of Cheniere Energy.[110] Insiders at two NASDAQ small capitalization companies, Comprehensive Environmental Systems, Inc. and ICIS Management Group Inc., were indicted for criminal violations of the securities laws after selling stock through Regulation S to entities controlled by the insiders and

& Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301 (1983) (showing concern for organizations where the decisionmakers do not "bear a substantial share of the wealth effect of their decisions"); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-10 (1976) (noting that managers of corporations do not possess the same interest in the firm that they would have if in a partnership or sole proprietorship).

108. *See supra* Parts II.A.1, II.A.2 (discussing the gain to pre-offering shareholders of an issuer selling overvalued securities into the market).

109. *See* Cheniere Energy, Inc., *Form 8-K Current Report*, Item 9 (Aug. 27, 1997), *available at* http://www.freedgar.com (on file with the *Duke Law Journal*).

110. *See id.*

then directing the sale of these securities to brokerage accounts in the U.S. owned by the insiders.[111]

Where the offering discount is due to insiders engaging in self-dealing, Regulation S may pose a threat to the interests of U.S. investors. Of course, insiders may engage in self-dealing through discounted sales of securities to related entities domestically. Indeed, insiders may use other mechanisms to extract value from a company other than securities self-dealing; for example, an insider may divert a corporate opportunity for her own use.[112] Nevertheless, Regulation S provides a particularly effective means of facilitating insider self-dealing to the extent that investors have more difficulty in tracing the identity of purchasers across the borders of multiple countries in an offshore securities offering.

Consider Texon, Inc. again. Assume now for simplicity that the pre-offering U.S. secondary market price is $70 per share, exactly matching the company's fundamental value. The market, in other words, does not overvalue Texon's securities. Managers, nevertheless, may benefit through a Regulation S offering to the extent that they engineer a sale to entities in which the managers themselves have an ownership interest. Suppose that Jane is the CEO of Texon. Jane sets up an offshore entity called Sailboat Ltd., taking a 100% equity interest in Sailboat. Sailboat purchases one million shares of Texon through a Regulation S offering at $40 per share, well below the pre-offering fundamental value of $70 per share. As a result of the steeply discounted offering, Texon's post-offering fundamental value drops to only $55 per share.[113] If Sailboat is able to resell into the United States prior to information disclosure on the offering at the pre-offering secondary market price of $70, Jane will gain $30 per share at the expense of both new U.S. purchasers and pre-offering Texon shareholders. Even where the secondary market reacts accurately to

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111. *See Former SEC Lawyer, Others Indicted on Charges Over Reg S Securities*, 28 SEC. REG. & L. REP. 1242, 1242 (1996). Similarly, the chairman and CEO of Members Services Corp. was convicted of securities fraud after causing Members to sell 1.4 million shares of unregistered stock under Regulation S to several entities controlled by the chairman. The chairman then sold the Regulation S shares into the United States through the offshore entities into the United States at a substantial profit. *See SEC Announces First Conviction for '33 Act Regulation S Violations*, 28 SEC. REG. & L. REP. 605, 605-06 (1996).

112. For a case discussing the diversion of a corporate opportunity by a corporate officer, see Energy Resources Corp. v. Porter, 438 N.E.2d 391 (Mass. App. Ct. 1982).

113. With the addition of one million shares sold at $40 per share, Texon gains $40 million in additional capital, raising its total fundamental value to $110 million. With two million shares of stock outstanding post-offering, Texon's per share fundamental value will equal $55 per share.

news of the offering and the market price drops to $55 per share to reflect the post-offering fundamental value, Jane will still gain $15 per share at the expense of pre-offering investors in Texon.[114]

2. *Suboptimal Capital Investment Transactions.* Managers may utilize offshore securities offerings to benefit themselves at the expense of pre-offering shareholders even without engaging in a direct self-dealing transaction. Up to this point, this Article has assumed that the issuer places all additional capital raised through a securities offering in an interest-bearing bank account.[115] Nevertheless, how the issuer actually uses the additional capital affects the issuer's valuation. Companies, for instance, may not possess the capacity to employ additional capital productively. Worse still, managers may divert some of the offering proceeds to their own uses.[116] Managers, for example, intent on increasing their own welfare at the expense of shareholders, may expand the issuer's business unnecessarily.[117] Similarly, managers may increase their own compensation or expend resources for their own personal benefit, including office accommodations, transportation, and other possible expenses.[118]

For instance, assume that Texon's management seeks to conduct a Regulation S offering to raise funds in order to upgrade the corporate offices. An offering of one million shares at $70 per share, the pre-offering fundamental value of the company, will result in a total of $70 million with which managers can upgrade their corporate offices. Assume that the cost of the upgrades is $20 million and that the upgrades provide absolutely no benefit to the shareholders of the issuer. In this case, the issuer will have a post-offering total valuation of $120 million and two million shares outstanding, giving a per share

114. Note that new U.S. purchasers, however, will not systematically be harmed to the extent that they pay the secondary market price after the market reacts to news of the offering. The harm is solely on the pre-offering shareholders of Texon.

115. *See supra* note 56 and accompanying text.

116. Companies may, of course, allocate offering proceeds to use for shareholder wealth-increasing activities. For example, a company may use the offering proceeds to develop a new product that generates large profits for the company.

117. *See* Easterbrook & Fischel, *supra* note 62, at 705:

> Because managers have only a small stake in the fortunes of the firm, these costs may be quite high. Managers may not work as hard as they would if they could claim a higher share of the proceeds—they may consume excessive perquisites, and they may select inferior projects for the firm without bearing the consequences of their action.

118. *See id.*

fundamental value of $60.[119] Investors in the company thus lose $10 per share due to the Regulation S offering.

Several important observations may be noted regarding the possibility of suboptimal capital-raising activities on the part of management. First, foreign investors that expect managers to engage in a Regulation S offering simply to raise capital to serve the managers' own personal needs will seek a larger offering discount. On average, the discount must ensure that the foreign investors receive a competitive rate of return on their investment. In the Texon example above, foreign investors will not pay $70 when they expect that managerial diversion of the proceeds from the offering will result in a post-offering fundamental value of only $60 per share. Instead, foreign investors will pay no more than $50 per share, the price that ensures foreign investors that the post-offering shares they receive will equal the price they pay for the shares.[120] A large Regulation S discount, therefore, may represent the discount foreign investors demand in situations where they expect managers to engage in suboptimal capital investments.

Second, regardless of whether foreign investors obtain a discount, pre-offering U.S. shareholders in the issuer are harmed when managers use a Regulation S offering to raise a suboptimal level of capital. Significantly, however, the harm is not connected in any way to the possibility of resales into the United States. Even where foreign investors never resell into the United States, the fact that a large number of shares with identical voting, liquidation, and dividend rights are issued in return for capital that managers may squander results in harm to pre-offering shareholders. In other words, the harm to pre-offering U.S. shareholders comes from the diversion of the offering proceeds for the benefit of management; no additional harm comes from resales of the issued securities into the United States.

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119. Under assumptions of the hypothetical, Texon starts with a total pre-offering fundamental value of $70 million. The offering raises an additional $70 million. After subtracting the $20 million wasted on the office upgrades, the post-offering total fundamental value equals $120 million.

120. If foreign investors pay $50 per share, Texon will raise a total of $50 million from the offering. After taking into account the $20 million office-upgrade expenditure, the total valuation of Texon will equal $100 million. Given two million outstanding shares post-offering, the per share fundamental value will equal $50.

C. Other Causes for Concern

A separate concern may exist that Regulation S offerings simply occur at too great a discount, benefiting foreign investors at the expense of U.S. investors. Some may argue that, as a matter of fairness, U.S. investors should also have the ability to purchase the issuer's securities at the same discounted prices as foreign investors.[121] Several responses to this claim are possible, however.

First, much of the discount may be related either to managerial self-dealing or the overvaluation in the U.S. secondary market of the issuer's securities. For a large discount due to managerial self-dealing, the real problem is not the discount itself but the frequency of managerial self-dealing. Targeted reform, as discussed later in this Article, aimed at managerial self-dealing may be more effective in protecting investors than simply imposing restrictions on Regulation S resales in general.

Similarly, discounts due to overvaluation in the U.S. market may not necessarily be harmful to U.S. investors. Where the discount simply compensates foreign investors for the expected drop in secondary market prices prior to resales into the United States, the discount does not harm U.S. investors but instead ensures that foreign investors do not systematically lose on their investments.[122] Without such an assurance, foreign investors may choose not to invest. On the other hand, where the discount represents the negotiated share of the overvaluation surplus foreign investors receive for assisting issuers to sell overvalued securities into the United States, the discount does harm U.S. investors. Whether U.S. investors are harmed therefore depends on the timing and accuracy of the market reaction to news of a Regulation S offering.

Second, the discount may not be related to either managerial self-dealing or overvaluation of the issuer's securities in the U.S. secondary market. Compensation, for instance, may be required for the illiquidity that foreign investors bear during the Regulation S restricted period.[123] Where, for example, only a small fraction of an issuer's capital stock is sold overseas, foreign investors may be forced

121. *See* Jordan, *supra* note 34, at 86 ("[M]any American investors have perceived these discounts as providing an unfair market advantage to foreign investors.").

122. *See supra* notes 94-95 and accompanying text.

123. *See* Offshore Offers & Sales, *supra* note 10, at 9639 ("The size of that price discount reflects, at least in part, the compensation buyers of shares receive for giving up the ability to readily sell the shares immediately in the public market.").

to resort to the U.S. as a liquid market in which to conduct resales. During the restricted period, therefore, foreign investors are effectively locked into their securities investment, unable to sell the securities for liquidity needs or rebalance their portfolio after a shift in the market value of the securities.[124]

Foreign investors may also lack full information on the fundamental value of the issuer. As a result, foreign investors—like any other investor—may face a mispricing risk that will result in overpayment for the issuer's securities. Rather than act as a conduit for an issuer seeking to sell overvalued securities into the United States, foreign investors may become victims of overvaluation themselves. To compensate for the mispricing risk, foreign investors will demand an additional discount before agreeing to participate in the issuer's Regulation S offering.

Significantly, discounts designed to induce an investor to purchase securities in the company do not necessarily harm pre-offering shareholders of the company. In thinking about whether U.S. investors are harmed, it is important to consider the motivations of the issuing company's management. Suppose again that Jane is the CEO of Texon, Inc. Texon is considering a Regulation S offering to Saejoon, a Korean-based investor unrelated to Jane. Moreover, assume that Jane does not plan to divert any of the offering proceeds for her own use. Under such circumstances, Jane will sell at below $70 per share, the fundamental value of Texon, only where the benefit exceeds the dilution cost to the pre-offering shareholders. Doing otherwise would only dilute the pre-offering shareholders, including Jane herself to the extent that she owns shares in Texon. Even if Jane were not an investor of Texon, she would face the negative reaction of her own shareholders once information on the Regulation S discount is made public.

Company management may be willing to offer a discount for the issuer's securities to compensate foreigners for the lack of liquidity or the mispricing risk that foreign investors face because the issuer needs to raise capital for a value-increasing project and the cost of issuing securities inside the United States through a secondary offering is greater. Issuing within the United States may result in a higher expected cost to issuers due to, for instance, the costs of complying with

124. The illiquidity risk, therefore, may be greater for more volatile securities to the extent that such securities necessitate more constant portfolio rebalancing due to their rapid shifts in value. Thanks to Jim Cox for this point.

the registration requirements of section 5 of the Securities Act.[125] Such costs include not only the direct compliance expense but also the prospect of potentially frivolous lawsuits filed against the issuer.[126] Where the cost of frivolous lawsuits is high, issuers may consider a discounted sale to foreign investors less costly than a registered sale into the United States.[127] Pre-offering shareholders in the issuer, therefore, gain, despite the discount given to compensate foreigners for illiquidity or mispricing risks, to the extent that the company's value increases from the additional source of capital available at a cheaper cost than selling securities inside the United States.

III. EMPIRICAL TESTS OF THE REGULATION S OFFERING DISCOUNT

The magnitude of both the overvaluation and managerial opportunism risks to U.S. investors from a Regulation S offering correlates with the size of the offering discount from the U.S. secondary market price at the start of the offering. In the case of insider self-dealing, the greater the discount, the more value that managers divert from pre-offering shareholders. A larger discount may also represent compensation to foreign investors for the managers' planned suboptimal use of the offering proceeds. In contrast, a large offering discount may not indicate a corresponding harm to U.S. investors where the discount is simply compensation to foreign investors unable to resell into the United States until after the secondary market price responds

125. Studies have found that issuers going public for the first time inside the United States that raise at least $10 million can expect expenses of 10% of the offering amount. *See* Jay R. Ritter, *The Costs of Going Public*, 19 J. FIN. ECON. 269, 272-73 (1987). A good portion of these expenses, nevertheless, go to non-regulatory expenses, such as the underwriter's fee. Sara Hanks, the former Chief of the SEC's Office of International Corporate Finance who led the team that drafted the original Regulation S, wrote:

> It is no wonder that U.S. issuers favor a direct Regulation S transaction of this sort. Transaction costs are approximately ten percent of those involved in a public offering, and the transaction can be completed in days. This timing advantage is especially helpful where a company needs money fast to complete an acquisition, complete a build-out, or simply stay solvent.

Hanks, *supra* note 7, at 313–14.

126. For example, in an earlier study, Bohn and Choi estimated that the expected cost of settlement payouts for securities fraud class actions to all issuers engaging in an initial public offering is equal to 1.1% of the offering amount. *See* James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 981 & n.215 (1996). Of course, to the extent that not all litigation is frivolous, the expected settlement payout overestimates the cost to issuers of potential frivolous litigation.

127. For a study examining the cost of U.S. regulatory protection, see Stephen J. Choi, Assessing the Cost of Regulatory Protections: Evidence on the Decision to Sell Securities Outside the United States (working paper, on file with the *Duke Law Journal*).

negatively to news of the Regulation S offering. An offering discount that represents compensation for the illiquidity or mispricing risk facing foreign purchasers does not necessarily result in harm to U.S. investors. Where managers grant such a discount in an arms-length negotiation and are not acting opportunistically, pre-offering shareholders benefit more than they lose from the discounted sale. Section A of this part discusses the evidence relating to the overvaluation risk facing U.S. investors. Then, in Section B, this Article tests whether factors related to insider opportunism in fact determine the discount received by foreign investors in a Regulation S offering.

A. The Overvaluation Risk

Little empirical evidence exists on the efforts of domestic issuers to sell overvalued securities into the United States indirectly through a Regulation S offering. In a recent study of 192 Regulation S offerings, Aggarwal, Gray, and Singer hypothesize that some offerings prior to the SEC's 1996 reporting reform were sold to foreign investors with enough lead time prior to the issuer's subsequent Form 10-Q filing to provide foreign investors with an option to resell into the United States before the market received information on the offering.[128] They find, among other things, that offerings with a predisclosure resale option received a greater discount than offerings that occur without a resale option.[129]

The Aggarwal, Gray, and Singer study, however, arguably suffers from several flaws. First, the authors admit that the difference in the discount they find between offerings sold with the option to resell into the United States prior to information disclosure and those without such an option is not statistically significant.[130] Moreover, even if the difference were statistically significant, this Article's theoretical discussion above calls into question the interpretation of a greater

128. *See* Reena Aggarwal et al., *Capital Raising in the Offshore Market*, 23 J. BANKING & FIN. 1181, 1190-91 (1999); *see also supra* note 6 (listing Form 10-Q among the other periodic information disclosure filing forms). Among other things, the 1996 reporting reform required issuers to disclose information on equity-related Regulation S offerings within 15 days of the offering. *See supra* notes 49-50 and accompanying text (describing the SEC's 1996 reporting reforms).

129. *See* Aggarwal et al., *supra* note 127, at 1191 (reporting that offerings sold with the "option" to resell into the United States prior to the next scheduled Form 10-Q disclosure had a mean discount of 35.77% in comparison to the mean discount of 20.00% at which offerings without such an option were sold).

130. *See id.* at 1192.

discount for offerings with a pre-disclosure resale option.[131] Because foreign investors will negotiate for a greater discount where they are unable to sell prior to disclosure of the Regulation S offering, those investors with a pre-disclosure resale option should receive a *reduced* discount, all other things being equal.[132] Second, Aggarwal, Gray, and Singer's pre-reporting reform sample suffers from sample bias to the extent that their collection methodology misses many of the Regulation S offerings. The authors look to only Form 10-Q filings to uncover pre-reporting reform issuers;[133] however, issuers may disclose the fact of a Regulation S offering through press releases and other forms of SEC filings, including Form 10-K filings. The Aggarwal, Gray, and Singer study, therefore, provides only inconclusive evidence on the harm posed through Regulation S offerings.

In an earlier article, I also examine the issue of whether companies utilized Regulation S to sell overvalued securities into the United States prior to the SEC's 1996 reporting reform.[134] After the 1996 reporting reform, one would expect a much-decreased ability on the part of managers to use Regulation S to sell overvalued securities into the United States. As discussed above, a small discount relative to the overvaluation surplus may indicate that foreign investors are assisting managers to sell overvalued securities into the United States.[135] On the other hand, a large discount equal to the overvaluation surplus may indicate that no resales ahead of information disclosure are possible and that foreign investors are simply receiving compensation for the expected drop in the market price they will bear.[136] To the extent that managers were successful in using Regulation S to resell overvalued securities into the United States prior to the 1996 reporting reform, one would expect a lower offering discount compared with the post–reporting reform period, all other things being equal. The earlier article reports that the mean and median offering discounts for

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131. *See supra* Part II (discussing the relationship between the offering discount and the expected market reaction to news of the Regulation S offering).

132. The exact size of the discount depends on the relative bargaining powers of the issuer and the foreign investors. *See supra* notes 80-81 and accompanying text.

133. *See* Aggarwal et al., *supra* note 128, at 1186-87. In addition, to the extent that an attempted resale by a foreign investor itself signals information to the market, theoretically it is unclear that the authors are correct in arguing that foreign investors that purchase well before a Form 10-Q filing enjoy an option.

134. *See* Stephen Choi, *Resales of Offshore Securities into the United States: Evaluating the Overvaluation Risk to U.S. Investors* 78 WASH. U. L.Q. (forthcoming Summer 2000); *see also supra* notes 49-50 and accompanying text (describing the SEC's 1996 reporting reforms).

135. *See supra* Part II.

136. *See id*.

Regulation S offerings are not statistically different between the pre- and post–reporting reform periods, providing evidence against the hypothesis that managers were able to engage in overvaluation-driven Regulation S offerings prior to the SEC reporting reforms.[137] Even controlling for changes in the illiquidity and mispricing risks that investors bear, the discount did not increase post–reporting reform.[138]

Significantly, the Aggarwal, Gray, and Singer study and my earlier work both focus on the ability of foreign investors to resell ahead of a U.S. market reaction to the Regulation S offering prior to the SEC's 1996 reporting reform.[139] After the reporting reform, the increased information on Regulation S offerings disclosed to the market prior to resales enables the market to adjust the price for possible overvaluation.[140] To the extent that the 1996 reporting reform reduced the risk of overvaluation resales for U.S investors, the risk of insider opportunism became relatively more significant in assessing the desirability of the SEC's subsequent tightening of the Regulation S resale restrictions in 1998.[141] The next section presents this Article's tests on the possibility of insider opportunism through Regulation S.

B. The Risk of Managerial Opportunism

Using a dataset of 701 equity and equity-related offshore offerings from 1993 to 1997, this Article presents an empirical test of the possibility of insider opportunism through Regulation S offerings. This section first describes the Article's dataset of Regulation S offerings. Then the section reports on the empirical test of the presence of insider self-dealing in Regulation S offerings.

1. *Sample Description and Summary Statistics.* Searches through Exchange Act–reporting filing Forms 10-K, 10-Q, and 8-K on Lexis and Westlaw as well as the SEC's own Internet version of the EDGAR database were conducted to identify Regulation S equity

137. *See generally* Choi, *supra* note 134 (reporting that the pre-reform offering discount for non–Rule 144A offerings is 24.97% compared with 22.13% for the post-reform time period).

138. *See id.*

139. *See* Aggarwal et al., *supra* note 128, at 1185; Choi, *supra* note 134.

140. *See supra* Part II.A.3 (discussing the impact of an accurate market reaction to news of a Regulation S offering); *supra* Part II.A.4 (discussing the impact of an inaccurate market reaction to news of a Regulation S offering).

141. *See supra* Part II.A.3 (noting that a Regulation S offering may be motivated by a desire to maximize the wealth of present shareholders); *supra* Part II.A.4 (describing ways in which insiders may use Regulation S offerings to their own advantage).

offerings from January 1, 1993, to December 31, 1997.[142] Press releases and articles in the *Wall Street Journal* were also searched using the PR-Newswire and *Wall Street Journal* databases on Westlaw.

The resulting dataset contains two major limitations. First, only firms subject to the periodic reporting requirements of the Exchange Act were included due to data constraints.[143] Because of the limitation to only Exchange Act–reporting companies, this Article's empirical findings may not apply to smaller, non-Exchange Act–reporting issuers, including issuers that are not listed on a national securities exchange and that fail to meet the SEC's minimum net asset and number of shareholders requirements for Exchange Act reporting status.[144]

Second, prior to the 1996 reporting reform,[145] issuers disclosed information on the offering in one of their SEC filings or financial statements only to the extent that the offerings were "material" to the understanding of some other required information disclosure item.[146] For example, some issuers disclosed information on Regulation S offerings in their required discussion on capital resources under Item 7 of the annual Form 10-K filing.[147] Regulation S offerings prior to the reporting reform, therefore, comprise only a subset of the entire universe of Regulation S offerings. This subset, moreover, may be biased toward offerings where the issuer believed that disclosure of the offering outweighed any negative effects from disclosure. Nevertheless, due to the materiality requirement for SEC filings, the search uncov-

142. *See* Form 8-K, 5 Fed. Sec. L. Rep. (CCH) ¶ 31,001 (Oct. 6, 2000); Form 10-Q, 5 Fed. Sec. L. Rep. (CCH) ¶ 31,033 (Feb. 24, 1999); Form 10-K, 5 Fed. Sec. L. Rep. (CCH) ¶ 31,101 (Feb. 24, 1999). The SEC's online version of the EDGAR database is located on the Internet at *EDGAR Database of Corporate Information*, http://www.sec.gov (last visited Nov. 10, 2000) (on file with the *Duke Law Journal*).

143. *See supra* note 25 (describing the requirements for Exchange Act–reporting companies).

144. *See id.*

145. *See supra* notes 49-50 and accompanying text (describing the 1996 changes in disclosure requirements).

146. *See* 17 C.F.R. § 230.408 (2000) (stating that the registration statement also requires "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading").

147. Exchange Act–reporting companies must make an annual Form 10-K filing with the SEC. *See supra* note 6 (describing the periodic disclosure requirements of the Exchange Act). Item 7 of Form 10-K, in turn, requires the disclosure of information described in Item 303 of Regulation S-K. *See* 17 C.F.R. § 229.303; Management's Discussion and Analysis of Financial Condition and Results of Operation, 5 Fed. Sec. L. Rep. (CCH) ¶ 31,104 (Dec. 23, 1998). Issuers may also voluntarily disclose their Regulation S offerings under Item 5 of Form 8-K to the extent that the offering is of sufficient "importance." Form 8-K, 5 Fed. Sec. L. Rep. (CCH) ¶ 31,003 (Oct. 6, 2000).

ered the majority of larger size offerings. After the 1996 reporting reform, this Article's search tracked all the Regulation S offerings through the required Form 8-K disclosure.[148]

Table 1 reports the number of Regulation S offerings in this Article's data sample by year for all the offerings in the sample and for those offerings not part of a Rule 144A global offering.[149] Rule 144A offerings differ from stand-alone Regulation S offerings in a number of important ways. Technically only a resale exemption, Rule 144A provides purchasers of a Regulation S offering the ability to resell purchased securities quickly to qualified institutional buyers (QIBs) comprised mostly of large financial institutions.[150] The prospect of an immediate and liquid secondary market may result in a diminished discount for Rule 144A-related Regulation S offerings.[151] Rule 144A prohibits securities sold under its provisions from consisting of the same class of any security of the issuer listed on a U.S. securities exchange or traded on an automated U.S. interdealer quotation system, such as NASDAQ (the "nonfungibility" requirement).[152] Securities convertible into a security that does trade on NASDAQ or a national securities exchange are considered in violation of the nonfungibility requirement unless a conversion premium of at least 10% is applied.[153]

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148. *See supra* note 50 and accompanying text (describing the 1996 reporting reform).

149. The SEC estimates that, among Exchange Act–reporting companies, approximately 550 Regulation S offerings occur per year. *See* Offshore Offers & Sales, *supra* note 10, at 9639. Thus, the data set collected represents only a subset of the total number of offerings. Nevertheless, so long as the subset is representative of the entire pool of Regulation S offerings, the results from the data set apply to the entire group of offerings.

150. Rule 144A(a)(1) of the Securities Act defines a Qualified Institutional Buyer as an institutional entity that "in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity." 17 C.F.R. § 230.144A(a)(1)(i). Dealers registered pursuant to section 15 of the Exchange Act must meet only a $10 million requirement. *See id.* § 230.144A(a)(1)(ii). For the securities of non-Exchange Act–reporting issuers, the purchaser has the right to demand certain specified information at its discretion. *See id.* § 230.144A(d)(4).

151. The PORTAL market provides QIBs a forum to execute and settle transactions in nonregistered securities pursuant to Rule 144A. For a particular issuer's securities to trade in the PORTAL market, the National Association of Securities Dealers must first grant their approval. *See* HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 83-84 (4th ed. 1997) (describing the PORTAL market). Due in part to the PORTAL market, the quantity of resales taking advantage of Rule 144A has grown dramatically. From eight placements totaling $916.0 million in 1990, the use of Rule 144A grew to 243 placements totaling $44.672 billion in 1993. *See* Staff Report on Rule 144A, [1994-1995 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 85,428 (Aug. 18, 1994).

152. *See* 17 C.F.R. § 230.144A(d)(3)(i).

153. *See id.*; *see also* Beller, *supra* note 45, at 179 (noting that the average conversion premium for Rule 144A offerings that include a tranche of securities issued under Regulation S was "well above the 10% threshold required under Rule 144A").

Many of the Rule 144A offerings also involve concurrent placements inside the United States and therefore more regulatory protections for investors than purely overseas Regulation S offerings.

Table 1:
Number of Regulation S Offerings over Sample Time Period

Year	Number of Offerings	Mean Offering Amount ($ millions)	Median Offering Amount ($ millions)	Market Capitalization of the Issuer ($ millions)
1993	30	195.0	16.9	1147.8
1994	88	15.2	2.3	204.8
1995	120	18.4	2.6	480.2
1996	249	28.4	2.2	218.1
1997	214	43.3	2.0	400.0
Total	701	36.6	2.3	356.1

Number of Non–Rule 144A Regulation S Offerings

Year	Number of Offerings	Mean Offering Amount ($ millions)	Median Offering Amount ($ millions)	Market Capitalization of the Issuer ($ millions)
1993	21	104.9	7.0	174.1
1994	82	7.3	2.0	65.6
1995	109	6.1	2.2	326.4
1996	216	5.5	1.5	70.5
1997	174	7.7	1.5	101.4
Total	602	9.3	1.8	128.7

Note from Table 1 that Regulation S offerings in the 1993 portion of the data sample were both small in number and had a significantly larger mean offering amount relative to other years in the data sample. Compared to the 1997 mean offering amount of $43.3 million, the difference with the 1993 mean offering amount of $195 million is

significant at the 5% confidence level.[154] Two possible explanations exist for this shift. First, in 1993 Regulation S issuers may have generally issued larger dollar amounts of securities. Second, as discussed above, this Article's data collection methodology may miss smaller offering amount issuers in 1993. This Article, therefore, cannot rule out the possibility of data sample bias for the pre–SEC reporting reform years.

In Table 2, below, five different types of equity and equity-related securities offerings are tracked:[155] (1) common stock, (2) nonconvertible preferred stock, (3) convertible preferred stock, (4) convertible debt securities, and (5) other types of equity-related securities (including warrants).

Table 2:
Breakdown of Regulation S Offerings by Security Type

Security	Number of Offerings	Percent of Total Reg S Offerings	Mean Offering Amount ($ millions)	Median Offering Amount ($ millions)
Common	378	53.9%	7.18	1.50
Preferred Nonconvertible	4	0.6	6.13	7.50
Preferred Convertible	102	14.6	60.96	4.19
Debt Convertible	209	29.8	69.50	5.38
Other	8	1.1	52.93	35.49
Total	701	100.0	36.43	2.28

The majority of offerings in the dataset are for common stock. However, common stock offerings tend to be for a smaller offering amount, with a mean of $7.18 million. As Table 3 below reports, companies that trade on NASDAQ tend to engage in a greater pro-

154. Put another way, no greater than a 5% chance exists that the 1997 and 1993 offering amounts are drawn from the same underlying distribution. The statistical significance of the difference between the 1997 and 1993 mean offering amounts was assessed using a two-sided t-test of the means.

155. The original Regulation S did not provide a formal definition of "equity" security. In application, debt securities that provided for conversion into an equity security within the one-year restricted period for debt securities were considered as equity. Debt securities that provided for conversion only after the one-year restricted period for debt were not considered equity. *See* Lander, *supra* note 1, at 372-74. The conversion time period for all convertible debt securities in this Article's data set were examined to ensure that the conversion period occurred prior to the end of the one-year restricted period.

portion of the Regulation S offerings than those traded on the New York Stock Exchange (NYSE).

Table 3:
Breakdown of Regulation S Offerings by Securities Exchange

	Number of Offerings	Percentage of Total Reg S Offerings	Mean Offering Amount ($ millions)	Percentage of Offerings That Were for Common Stock
NYSE	89	12.7%	172.04	29.2%
AMEX	32	4.6%	6.84	78.1%
NASDAQ	578	82.7%	18.55	56.4%
Total	699	100.0%	36.48	53.9%

2. *Testing the Presence of Managerial Opportunism.* The degree of harm U.S. investors face from managerial opportunism depends on the magnitude of the offering discount. In the case of insider self-dealing, a greater discount allows insiders to extract a large amount of value per share from the pre-offering shareholders for the benefit of entities in which the insiders own an equity interest.[156]

The dataset, in turn, provides significant evidence on a summary statistic level that Regulation S offerings are sold at a substantial discount relative to the secondary market price measured at the time of the offering.[157] Table 4 reports the mean and median offering discounts for all common stock offerings and issues convertible into common stock in the dataset. For common stock offerings, the offering discount is calculated directly from the offering price and the U.S. secondary market price on the first date of the offering. For offerings of securities convertible into common stock, the conversion price into

156. Even with a small discount, insiders may extract a large total amount of value from the issuer and to their own private accounts through an offering of a large quantity of securities to entities in which the insiders own an equity interest. However, the offering of a large quantity of securities may draw unwanted attention to the insider's self-dealing activities.

157. The offering discount is defined as:

$$\text{Offering Discount} = \frac{\text{Offering Price - U.S. Secondary Market Price at Start of Offering}}{\text{U.S. Secondary Market Price at Start of Offering}}$$

common stock is adopted as the Regulation S offer price.[158] For issuers that employ a conversion formula rather than a single conversion price, this Article calculates a conversion price assuming that the secondary market price at the time of conversion equals the secondary market price at the start of the offering.[159] The offering discount is then calculated based on the conversion price and the U.S. secondary market price on the first date of the offering. Table 4 also reports the mean and median offering discount for the subset of non–Rule 144A Regulation S offerings in the sample.

Table 4:
Summary of the Regulation S Offering Discount

The Regulation S offering discount is calculated based on the U.S. secondary market price at the start of the offering. The net discount is calculated only for common stock offerings and issues convertible into common stock.

Type of Offering	Observations	Mean Discount	Median Discount	p-value
All Regulation S	476	-16.46%	-20.00%	0.0000**
Non-144A	400	-23.74%	-25.00%	0.0000**

** 5% level. p-value is from two-sided t-test of the difference of the mean from zero.

As Table 4 demonstrates, the offering discount for the entire sample of Regulation S offerings was -16.46% relative to the secondary market price at the start of the offering (significant at the 5% level). For non–Rule 144A offerings, the offering discount is even greater in magnitude at -23.74% (significant at the 5% level).

Despite the large size of the Regulation S offering discount, several possible explanations exist other than insider opportunism. Significantly, a large part of the discount may be related to the market reaction to news of the offering. As discussed above, no statistically significant evidence exists that foreign investors are able to use

158. The vast majority of convertible securities in the data set were sold through a Rule 144A offering. Due to the fungibility requirements of Rule 144A of the Securities Act, most Rule 144A offerings consist of convertible debt securities that are convertible after a period of time into the common stock of the issuer at a premium of greater than 10%. *See supra* note 151.

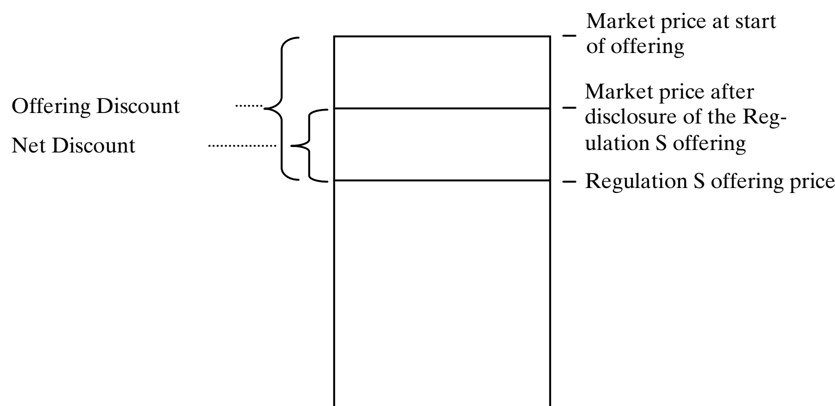
159. To the extent that the secondary market price at the time of conversion is systematically greater than the secondary market price at the start of the offering, for example, this Article's measure for the conversion price will understate the true conversion price. This Article, as a result, may overstate the offering discount for the securities of such issuers.

Regulation S to engage in resales of overvalued securities into the United States prior to information disclosure.[160] After the 1996 reporting reform, the ability of foreign investors to resell prior to information disclosure into the United States is severely curtailed. Thus, particularly in the post–reporting reform period, the offering discount incorporates compensation to investors for the secondary market price drop due to disclosure of the Regulation S offering.

Significantly, the part of the offering discount that represents compensation for the secondary market reaction simply provides foreign investors with a competitive rate of return for their investment. Without the discount, foreign investors that resold securities into the United States after the secondary market reaction would systematically receive a negative return, leading foreign investors to eschew Regulation S offerings. Foreign investors, in turn, may receive a greater than competitive return—for example, due to managerial self-dealing—only to the extent that the offering discount they receive exceeds the secondary market reaction.[161]

To measure the discount foreign investors obtain in excess of the secondary market reaction, this Article subtracts the secondary market price reaction to news of the offering from the offering discount resulting in the "net discount." Figure 1 graphically depicts the relationship of the offering discount with the net discount.

Figure 1: Offering and Net Discounts from a Regulation S Offering



160. *See supra* Part III.A (describing empirical evidence on the ability of foreign investors to resell into the United States ahead of information disclosure of the Regulation S offering).

161. This result again assumes that foreign investors are unable to resell prior to the secondary market reaction to news of the offering. This assumption is strongest for the post–reporting reform time period.

The net discount represents the discount foreign investors actually receive when they resell their securities into the secondary market after the market learns of the offering. To the extent that the secondary market reaction to news of the Regulation S offering is on average correct, the net discount therefore represents the discount foreign investors obtain from the issuer's *post-offering* fundamental value. The net discount, for example, may consist of a discount due to insider self-dealing, a discount for illiquidity, and a discount to compensate foreign investors for the risk they might misprice the issuer's securities. This Article uses the net discount in particular to test for the presence of managerial opportunism.

At least two possible criticisms are possible of the use of the net discount in the Article's empirical models. First, removing the market reaction component of the offering discount in generating the net discount may also remove that part of the offering discount that represents the post-offering drop in value due to the suboptimal use of capital raised from the offering. Where managers intend simply to waste all the Regulation S offering proceeds, for example, the post-offering fundamental value of the company's shares will fall. Once the market learns of the offering, the secondary market reaction will then take into account the manager's intention to waste the offering proceeds. Because the net discount focuses only on the offering discount in excess of the secondary market reaction, the net discount provides a means only to test for the presence of insider self-dealing and not the suboptimal investment of capital.[162]

Second, because the offering discount is determined prior to the actual secondary market reaction, the net offering discount investors expect to receive depends on the expected secondary market reaction at the time investors are negotiating the offering discount. Although on average the actual secondary market reaction will equal the expected secondary market reaction, for any particular offering, the two may not equal. To correct for this possible bias, the expected secondary market reaction is modeled directly in the Appendix and used to

162. Managerial self-dealing sales of highly discounted securities may also reduce the value of the corporation. The reduction in corporate value will, in turn, reduce the value of the shares the managers purchase from the corporation. The net offering discount, therefore, represents the net amount of value managers extract from the corporation. For example, consider Texon. Where managers sell one million shares at $50 per share to themselves, the value of the Texon shares will drop to only $75 per share from their original $100 per share. Managers then benefit only $25 per share from their self-dealing, equal to the net offering discount.

calculated the net discount. As the Appendix reports, the results using the net discount based on the expected secondary market reaction are similar to the results for the net discount calculated using the actual secondary market reaction.

a. Determining the Secondary Market Reaction. This Article assesses the secondary market reaction to news of a Regulation S offering through event study methodology.[163] Where the market for a particular company is efficient, the secondary market price will incorporate publicly announced information rapidly into the stock market price.[164] Examining the U.S. secondary market reaction to the offering, therefore, provides a means of gauging how the disclosed information affects shareholder welfare.[165]

To calculate the impact of the Regulation S offering on the secondary market price of a security, this Article utilizes the following steps. First, this Article selects an event time window for when information on the Regulation S offering reaches the U.S. secondary market. This Article tracks the returns from the start of the offering to both six weeks and eight weeks after the start as a match to the forty-day restricted period relevant for offerings during this Article's sample time period.[166] Because the forty-day restricted period is measured from the close of the offering,[167] Regulation S may limit resales even after six weeks from the start of the offering, depending on the dura-

163. *See* JOHN Y. CAMPBELL ET AL., THE ECONOMETRICS OF FINANCIAL MARKETS 149–78 (1997) (describing methods of event study analysis); Stephen J. Brown & Jerold B. Warner, *Using Daily Stock Returns: The Case of Event Studies*, 14 J. FIN. ECON. 3 (1985) (examining how the characteristics of daily stock returns affect event study methodologies for determining the share price impact of firm-specific events); A. Craig MacKinlay, *Event Studies in Economics and Finance*, 35 J. ECON. LIT. 13, 27 (1997) (using event study analysis to examine the null hypothesis, which holds that an economic event has no impact on the distribution of returns from stocks).

164. This Article's restriction of its data sample to only Exchange Act–reporting companies provides support for the efficient market assumption.

165. Event study methodology is often used to gauge the wealth effects of new information on shareholders. *See* Jean-Claude Bosch et al., *The Competitive Impact of Air Crashes: Stock Market Evidence*, 41 J.L. & ECON. 503 (1998) (analyzing stock market reactions to new information about commercial air crashes); Eugene Fama et al., *The Adjustment of Stock Prices to New Information*, 10 INT. ECON. REV. 1 (1969). For examples of event studies in the legal literature, see ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW *passim* (1993).

166. Prior to the SEC's 1998 reforms, U.S. Exchange Act–reporting issuers that sought to sell equity abroad through Regulation S faced a 40-day restricted period. *See* Original Regulation S, 17 C.F.R. § 230.903 (c)(2)(III) (1990). Domestic U.S. issuers seeking to sell equity securities through Regulation S now face a one-year distribution compliance period. *See supra* note 32 (describing the distribution compliance period requirements).

167. *See* Original Regulation S, Rule 902(m), 17 C.F.R. § 230.902(m).

tion of the offering. The eight-week event period is used to capture the information effects for longer duration offerings. In addition, this Article tracks returns from two weeks before the start of the offering to both six weeks and eight weeks after the start date to assess the information effect from any pre-offering announcements to the market.

Prior to the SEC's 1996 reporting reforms, Regulation S issuers faced no specific requirement that they disclose their Regulation S offerings.[168] Thus, investors would learn of the offering only when resales commenced in the United States after the forty-day restricted period.[169] Conversely, information about the Regulation S offering may have reached the U.S. equity markets earlier than the six-week and eight-week event windows for offerings that occurred after the 1996 reporting reform.[170] For post-reporting reform offerings, nevertheless, this Article's event windows capture disclosures from issuers slow to meet their obligation to report their Regulation S offerings.[171] For issuers that report their offerings in a timely manner, expanding the event window to time periods where no significant information is released to the market will, on average, not change the cumulative excess return. On the other hand, the standard error will increase, leading to a lower likelihood that the cumulative excess return will be statistically significant. To the extent that this Article finds a substantial market reaction post-reform using the six-week and eight-week event windows, therefore, the results are even more significant.

Second, daily secondary market common stock returns are collected from the Center for Research on Security Prices (CRSP) for each Regulation S offering.[172] Looking at the secondary market returns during the event window, however, may provide a misleading

168. *See supra* notes 146-46 and accompanying text (discussing materiality and other requirements that may have led issuers to disclose their Regulation S offering despite no specific disclosure mandate).

169. *See* 17 C.F.R. § 230.903 (2000). Indeed, foreign investors have, in the past, sold into the United States prior to the expiration of the 40-day waiting period. In 1996, for example, the National Association of Securities Dealers Regulation Inc. fined Alex, Brown & Son for assisting resales back into the United States before the end of the 40-day period. *See* National Ass'n of Sec. Dealers, Inc.: Alex Brown, Rep Agree to Fines over Sale of Regulation S Securities, 28 Sec. Reg. & L. Rep. (BNA) 1217 (Oct. 4, 1996).

170. *See supra* notes 49-50 and accompanying text.

171. For example, XXSYS Technologies Inc. conducted a $2 million common stock Regulation S offering on March 18, 1997, but did not file a Form 8-K reporting on the offering until May 16, 1997, almost two months after the offering. XXSYS Technologies, Inc., *8K Current Report* (May 15, 1997), *available at* http://www.freeedgar.com (on file with the *Duke Law Journal).*

172. The Center for Research in Security Prices is based at the University of Chicago Graduate School of Business.

picture of the impact of a Regulation S offering on the market price. Without any new information, investors will expect an equity investment to provide a risk-adjusted return equivalent to other substitute investments (the "expected return"). To separate the return due to the information effect from the expected return, this Article estimates the expected return for each issuer's common stock based on the market model.[173] The daily excess return is then defined to equal the unadjusted secondary market return minus the expected return; the excess return, therefore, represents a measure of the information's impact on the stock price of the issuer for a particular day.

Finally, daily excess returns are summed across time in the event window, giving the cumulated excess return (CER). The cumulated excess return is taken as the market's overall reaction to the new information. Table 5 reports the cumulative excess returns for the selected event windows.

Table 5:
Cumulative Excess Returns from Event Study
(All Regulation S Offerings)

Time Window	Observations	CER	t-statistic
+0 to +6 Weeks	382	-3.99%	-3.177**
+0 to +8 Weeks	381	-5.36%	-3.672**
-2 to +6 Weeks	379	-4.51%	-3.628**
-2 to +8 Weeks	377	-6.00%	-4.021**

** 5% level.

173. The market model treats the return for any security as a function of the total market return. For security i, for example, the expected return for time period t (R_{it}) is equal to:

$$R_{it} = \alpha + \beta_i R_{mt} + \varepsilon_{it}$$

where R_{mt} is the market return and ε_{it} is the zero mean disturbance term. *See* CAMPBELL ET AL., *supra* note 163, at 155 (describing the market model). A value-weighted return based on all the securities trading on the exchange in which the issuer's securities are listed is used for the market return. The value-weighted return for all NASDAQ securities is used for securities trading on NASDAQ. For each security, returns from -260 trading days to -20 trading days prior to the start of the offering are used to estimate the parameters of the market model.

Cumulative Excess Returns from Event Study
(Excluding Rule 144A Offerings)

Time Window	Observations	CER	t-statistic
+0 to +6 Weeks	300	-3.83%	-2.311**
+0 to +8 Weeks	299	-5.11%	-2.668**
-2 to +6 Weeks	298	-3.82%	-2.221**
-2 to +8 Weeks	296	-5.27%	-2.549**

** 5% level.

The event study provides evidence consistent with the hypothesis that news of the Regulation S offerings convey significant negative information to the securities markets.[174] Note from Table 5 that after a Regulation S offering issuers receive a strong negative cumulative excess return on average relative to the market. In particular, for all Regulation S offerings, the cumulative excess return is -5.36% for the +0 to +8 week event window (significant at the 5% confidence level);

174. Analysts also have conducted an event study around information disclosure of a Regulation S offering and find no statistically significant cumulative excess market return. *See* Aggarwal et al., *supra* note 128, at 1192-93. They focus, however, only on the filing date of the Form 10-Q immediately after the Regulation S offering. *See id.* As discussed above, using the Form 10-Q filing date is unreliable to the extent that information on the offering may reach the market prior to the filing date. *See supra* notes 132-32 and accompanying text. In the alternative, because issuers had no direct compulsion to disclose information on the offering in the Form 10-Q prior to the SEC's reporting reform, information on the offering may reach the market—through an increase in trading volume, for example—well after the Form 10-Q filing date. This Article's larger event window, therefore, provides a more accurate representation of the time period in which the market learns of the Regulation S offering.

Similar with this Article's finding of a negative market reaction for Regulation S offerings, Professors Kang, Kim, Park, and Stulz report a negative abnormal return to the announcement of an offshore convertible debt offering by a sample of U.S. issuers chosen to match a corresponding sample of Japanese issuers of equity-related debt securities. *See* Jun-Koo Kang et al., *An Analysis of the Wealth Effects of Japanese Offshore Dollar-Denominated Convertible and Warrant Bond Issues*, 30 J. FIN. & QUANT. ANAL. 257, 264 (1995) (reporting a statistically significant abnormal return of –1.35% for offshore U.S. convertible debt issues).

In a study of equity private placements into the United States from 1979 to 1985, Professor Wruck, in contrast, finds a positive secondary market reaction to news of an offering. *See* Sophie Hopper Wruck, *Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financing*, 23 J. FIN. ECON. 3, 8-9 (1989). In particular, where share concentration increases as a result of the offering, the secondary market reaction is even more positive. *See id.* at 10-23 (arguing that greater share concentration leads to both the increased monitoring of management and a raised probability of an eventual takeover). Wruck theorizes that private equity placements typically involve fewer numbers of purchasers able to negotiate with management for access to nonpublic information to gauge the value of the company. Private placement investors, therefore, face a reduced risk of purchasing overvalued securities; the public secondary market, as a result, assesses a different probability of overvaluation from news of a private placement than for a public offering. *See id.* at 10.

similarly, for the -2 to +8 week event window, the cumulative excess return is -6.00% (significant at the 5% confidence level).[175] U.S. investors that owned a particular Regulation S issuer's securities prior to the offering were harmed as the information about the offering resulted in a negative return. However, the harm is no different from the harm from any other form of negative information disclosure.[176]

b. Insider Self-Dealing and the Net Offering Discount. The net discount represents the amount below the post-disclosure secondary market price at which foreign investors are able to purchase an issuer's Regulation S securities. To the extent that foreign investors are unable to resell ahead of the secondary market reaction to news of a Regulation S offering, during the post-reporting reform period for example,[177] the net discount represents the true gain foreign investors receive at the expense of U.S. investors.

To calculate the net discount, this Article subtracts the eight-week cumulative excess return from the offering discount in the Regulation S offerings.[178] Table 6 reports the mean and median net discounts for all Regulation S offerings in the sample and the non–Rule 144A offerings where data exists on both the offering discount and the eight-week cumulative excess return.

175. Test statistics for significance based on the student-t distribution are calculated using the method described in Brown & Warner, *supra* note 163, at 28-29.

176. *See supra* notes 72-73 and accompanying text (arguing that the mere disclosure of truthful, negative information into the U.S. market overall benefits the United States).

177. Even during the pre–reporting reform period, evidence is inconclusive as to whether foreign investors could successfully resell prior to the secondary market reaction to news of a Regulation S offering. *See supra* notes 128-37 and accompanying text.

178. In other words:

Net Discount = Offering Discount – 8-Week Cumulative Excess Return

Table 6:
Summary of the Net Discount

The net discount is defined as the offering discount minus the eight-week cumulative excess return. The net discount is calculated only for common stock offerings and issues convertible into common stock.

Type of Offering	Observations	Mean Discount	Median Discount	p-value
All Regulation S	316	-4.00%	-3.85%	0.1354
Non–Rule 144A	245	-13.63%	-14.09%	0.0000**

** 5% level. p-value is from two-sided t-test of the difference of the mean from zero.

This Article tests the hypothesis that insider self-dealing is responsible for the magnitude of the net discount. Against this hypothesis, this Article pits the alternative hypothesis that the net discount is driven by illiquidity concerns as well as fears of mispricing the issuer's securities on the part of foreign investors due to the information disadvantage they face relative to the issuer.

To test among the different factors that explain the net discount, a multivariate ordinary least squares model is fitted using the net discount (*NDISC*) as the dependent variable. The model is represented in the following equation:[179]

$$NDISC = \alpha + X_1\beta_1 + X_2\beta_2 + X_3\beta_3 + X_4\beta_4 + X_5\beta_5 + \varepsilon$$

X_1 – Liquidity-Related Variables
X_2 – Mispricing Risk to Foreign Investors Variables
X_3 – Insider Opportunism Variables
X_4 – Control Variables
X_5 – Geographical Location Variables

Several independent variables are included in the model to distinguish among the theoretical factors that may result in a net discount. Table 7 summarizes the different independent variables.

179. In the model, α is the constant intercept term and ε is the zero mean stochastic disturbance term.

Table 7:
Description of Model Independent Variables

Category	Independent Variable
X_1: Liquidity-Related	Natural log of market capitalization
	Natural log of offering amount to market capitalization ratio
	Number of world contacts
X_2: Mispricing Risk to Foreign Investors	Natural log of market capitalization
	Dummy variable for fraud action
	Dummy for SIC 357 (Computers and Office Equipment)
X_3: Insider Opportunism	Fraction of board comprised of officers
	Fraction of common stock owned by directors and officers
	Dummy variable for board seats obtained as part of the offering
	Dummy variable for insider or block shareholder purchase
X_4: Control Variables	Dummy variable for common stock offering
	Dummy variable for Rule 144A offering
X_5: Geographical Location	Dummy variable for sale to Europe
	Dummy variable for sale to Canada
	Dummy variable for sale to Asia
	Dummy variable for sale to Central/South America
	Dummy variable for sale to Other (including Africa)

First, to determine whether the overseas liquidity of a Regulation S offering affects the discount which foreign investors demand, independent variables (X_1) related to overseas liquidity are added to the model. The greater the market capitalization of an issuer, the more likely that investors worldwide are familiar with the issuer, making it easier for foreign investors to resell the securities abroad. Similarly, the greater the offering amount sold overseas in relation to the total market capitalization, the greater is the likelihood of a significant resale market overseas. Where only a small fraction of an issuer's outstanding capitalization is sold abroad, for instance, trading activity will gravitate back to the United States, where most securities are located. The model therefore includes the natural log of the market

capitalization and the natural log of the offering amount to market capitalization ratio as measures of overseas liquidity.[180]

Companies with more foreign contacts will also present investors with a greater likelihood of finding investors abroad willing to trade in the companies' securities. Contacts overseas may take the form of either factories or other productive enterprises abroad or overseas export markets to which the company sells. To capture this possibility, the number of countries in which the firm either conducted operations or sold products and services is included in the model as the "number of world contacts." For each Regulation S issuer, the number of countries in which the firm either conducted operations or sold products and services was collected through examination of each firm's SEC Form 10-K filing concurrent with the year of the offering.[181]

Second, a series of variables (X_2) related to the risk foreign investors may face of mispricing the Regulation S securities are included in the model. Where foreign investors purchase with a view to hold the securities, for example, they face the risk that the securities are overvalued. Where foreigners instead purchase with a view to resell into the United States, they face a risk of mispricing the degree of overvaluation in the United States, leading to too little compensation from the issuer for the expected negative secondary market reaction prior to resale. With a similar effect as for liquidity, a greater market capitalization may result in an increased amount of information in the market on the issuer. The greater an issuer's market capitalization, for instance, the more analysts that will follow the issuer, reducing the mispricing risk to foreign investors.

In addition, to the extent that the issuer was involved in a private U.S. securities fraud action, the issuer may represent a greater risk of fraud to the overseas investors.[182] Two measures for fraud are there-

180. The natural log transformation is used to obtain a more normal distribution for the market capitalization and offering amount to market capitalization ratio independent variables.

181. This Article calculates the number of world contacts as follows: For each specific country mentioned in the Form 10-K filing, the number of world contacts is increased by one. Where the issuer's Form 10-K only discussed a particular continent, the average number of contacts other issuers in this Article's sample had in the particular continent conditional on the issuers' having at least one contact is used as the number of contacts for that continent. For example, in the entire sample, companies that listed at least one country in Europe on average listed five European countries. Issuers that listed Europe, therefore, have their number of world contacts increased by five.

182. On the other hand, not all fraud actions under the securities laws are merit-driven. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 500 (1991) (arguing that substantive and procedural legal rules, and

fore included in all the models. A dummy variable for whether the issuer was involved in a private securities fraud action anytime from ten years prior to the offering to three years after the offering is included.[183] Fraud actions occurring after the offering are included because issuers that actually are involved in a fraud action post-offering may have displayed characteristics to foreign investors prior to the offering that indicated a higher risk of fraud. Rational foreign investors, in turn, should demand a greater discount to the extent that they perceive an increased risk of fraud. As well, a dummy variable for Standard Industrial Classification (SIC), code 357 (Computer and Office Equipment)—the SIC Code with the highest frequency of securities fraud class actions in the 1996 Bohn and Choi study of securities fraud class actions related to initial public offerings[184]—is included in the model.

Third, to test the hypothesis that insider self-dealing may drive some of the offering discount, the model includes the fraction of corporate officers on the board as well as the fraction of outstanding shares owned by directors and officers as independent variables (X_3).[185] Firms with a higher degree of insider board representation, all other things being equal, will be more likely to sell securities to insiders at a discount through an offshore offering.[186] On the other hand, firms where managers own a significant fraction of shares will be less willing to bear the cost of selling discounted shares to the extent that they bear a greater cost of this discount due to their share ownership.[187] Both the fraction of the board composed of officers as well as the beneficial share ownership of directors and officers are included

economic incentives of the litigants, often drive suits brought under the securities laws); Bohn & Choi, *supra* note 126, at 981 (discussing settlement costs in securities fraud class actions).

183. This Article tracked any private fraud action brought under the securities laws including any action related to a securities offering or secondary market disclosure. To determine the securities fraud experience of a particular issuer, Form 10-K, 8-K, and 10-Q filings were searched on WESTLAW and LEXIS. For offerings that took place in 1997, fraud actions from ten years prior to only two years after the offering were tracked.

184. *See* Bohn & Choi, *supra* note 126, at 942-43.

185. Both the beneficial ownership of directors and officers and the composition of the issuer's board of directors were determined through examination of the issuer's proxy statement for the year of the offering.

186. Outside directors with some financial affiliation may tend to support management more than outside directors without such affiliations. Thus, outside directors that also serve as consultants, attorneys, or bankers to the company may act similarly with inside directors. This Article's focus on solely insider board representation, therefore, may not fully capture the degree of management influence on certain boards of directors.

187. *See supra* note 183 and accompanying text (discussing a possible nonlinearity in the relationship between the share ownership of management and the net discount).

in the model. In addition, the model includes dummy variables for whether the purchaser obtained a board seat as part of the offering and for whether the issuer voluntarily reported that an insider, affiliate of the insider, or a block shareholder purchased the securities.[188]

Fourth, the model incorporates a set of control dummy variables (X_4). A dummy variable is included for whether the offering was for common stock to control for differences in risk for varying securities with different voting, liquidation, and dividend rights in the issuer. For securities that are convertible into common stock, the use of a calculated offering discount based on the conversion price may also reflect the offering discount inaccurately. For investors choosing to convert, the conversion price does represent the price the investors must pay for the common shares. Not all foreign investors, however, may exercise their option to convert. In particular, the option not to convert is valuable; the offering discount calculated from the conversion price, therefore, may not represent the same price the foreign investor would have negotiated had the investor simply purchased common stock from the issuer. For example, the investor may agree to a higher conversion price in return for the option not to convert (resulting in a reduced calculated offering discount). Nevertheless, to the extent the Regulation S offering is being used to transfer value from the company to corporate insiders, one would expect an increased offering discount, even taking into account the potential option value built into the conversion price for convertible securities.

The model also uses a dummy variable to control for a Rule 144A offering.[189] Because purchasers of a Rule 144A offering typically enjoy the ability to engage in relatively inexpensive resale through the PORTAL market to qualified institutional buyers, one would expect a lower liquidity discount.[190] As well, the presence of Rule 144A offerings in the sample may skew the mean Regulation S discount. Rule

188. The dummy variables for the acquisition of a board seat and an insider purchase took the value of 1 where data existed that confirmed such an event. Without any information, the dummy variables were assigned a value of 0. A value of 0, therefore, may either indicate no such event or a lack of data on the acquisition of a board seat or an insider purchase. Block shareholders are defined as shareholders that beneficially own at least 5% of the company's common stock.

189. Rule 144A, 17 C.F.R. § 230.144A (2000); *see also supra* note 150 (describing the requirements of Rule 144A).

190. *See supra* note 151 (describing the PORTAL market). For a discussion of the liquidity benefits of a Regulation S discount, see *supra* note 151 and accompanying text. In addition, to qualify as nonfungible securities under Rule 144A, most Rule 144A–Regulation S offerings are conducted at above a 10% offering *premium*, leading to a decrease mean offering discount for the entire sample of Regulation S offerings. *See supra* note 150.

144A offerings of convertible debt securities typically are sold with a conversion right into the issuer's common stock. The conversion premium, moreover, is usually set at above 10% relative to the U.S. secondary market price at the time of the offering to meet the nonfungibility requirement of Rule 144A, resulting in a downward bias in the mean discount for the pool of all Regulation S offerings.[191]

Model 1 of Table 8 reports the results for the baseline model. To account for the possibility that foreign investors do not receive compensation for the expected secondary market reaction during the pre-1996 reporting reform period (and instead may engage in sales of overvalued securities into U.S. markets), this Article re-estimates Model 1 for the post–1996 reporting reform period only as reported as Model 2 in Table 8. Because of the required disclosure of the Regulation S offering within fifteen days to the U.S. securities markets in the post-reporting reform period,[192] the ability to engage in resales of overvalued securities is much diminished. The probability of foreign investors demanding a greater offering discount to account for information effects is therefore increased post reporting reform, leading to a more accurate calculation of the net discount.

A variation of the model is fitted as Model 3 with the addition of a series of dummy variables (X_5) related to the geographical region, where known, of the Regulation S offering (estimated for the post-reporting reform period only). The geographical region of the offering may impact the offering in several ways. Certain geographical regions have more robust and liquid capital markets. Geographical regions also differ in the amount of securities regulatory protections given to investors.[193] As well, foreign investors bear a foreign exchange risk when they purchase shares of U.S.-denominated securities. The magnitude of both the illiquidity and foreign exchange risks, moreover, will depend on the specific country in which the securities are being sold. Offerings into countries with relatively stable foreign currencies and large liquid capital markets will result in a reduced

191. *See supra* notes 150-51 and accompanying text (describing the nonfungibility requirement for Rule 144A resales).

192. *See supra* notes 49-50 and accompanying text (describing the 1996 reporting reforms).

193. Not all regulations result in a reduction in the offering discount. For example, in the United States, underwriters and issuers may agree to underprice securities relative to the expected secondary market price to reduce the risk of a frivolous lawsuit associated with the offering. *See, e.g.*, Seha M. Tinic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. FIN. 789, 798-800 (1988) (explaining underwriters' and issuers' efforts to avoid overpricing securities so as to avoid potential legal liability). To the extent that different countries vary in their risk of a frivolous lawsuit, one would expect a different level of discounting.

level of residual price discount. Dummy variables for offerings to Canada, Asia, Central/South America, and "Other" (including Africa) regions are included in the model to compare against offerings to Europe. Table 8 reports the results from Model 3.

Table 8:
OLS Model of the Net Discount

The net discount is defined as the offering discount minus the 8-week cumulative excess return. A more negative net discount corresponds to a larger discount from the secondary market price. The net discount is calculated only for common stock offerings and issues convertible into common stock.

Independent Variables	Model 1: Base Model	Model 2: Post-Reporting Reform Only	Model 3: Post-Reporting Reform Only With Geographical Controls
Natural Log of Market Capitalization	0.057**	0.084**	0.036
	(2.607)	(2.505)	(0.598)
Natural Log of Offering Amount to Market Capitalization Ratio	0.099**	0.145**	-0.020
	(4.538)	(4.382)	(-0.292)
Number of World Contacts	0.004	0.006	-0.003
	(0.979)	(0.942)	(-0.323)
Dummy Variable for Fraud	0.089	0.081	0.785**
	(1.620)	(0.853)	(2.961)
Dummy for SIC 357	0.055	0.098	0.209
	(0.599)	(0.779)	(1.329)
Fraction of the Board Composed of Corporate Officers	-0.036	-0.232	-1.247**
	(-0.262)	(-1.018)	(-2.589)
Fraction of Common Stock Beneficially Owned by Directors and Officers	0.231*	0.477**	1.242**
	(1.750)	(2.305)	(2.693)
Dummy Variable for Board Seat Purchase	-0.332*	-0.639**	-0.555**
	(-1.864)	(-2.791)	(-2.796)
Dummy Variable for Reported Sale to Insider, Insider Affiliate, or Block Shareholder	0.247	.	.
	(0.897)		
Dummy Variable for Common Stock	-0.146**	-0.194**	-0.087
	(-2.647)	(-2.276)	(-0.573)
Dummy Variable for 144A Offering	0.060	-0.101	0.720**
	(0.667)	(-0.678)	(2.439)

Dummy Variable for Europe	Base	Base	Base
Dummy Variable for Asia	.	.	-0.380** (-2.221)
Dummy Variable for Canada	.	.	-0.245 (-0.773)
Dummy Variable for Central/South America	.	.	-0.201 (-1.020)
Dummy Variable for Other	.	.	1.122** (2.881)
Constant	-0.084 (-0.692)	0.057 (0.326)	-0.098 (-0.295)
Observations	288	119	36
F-value	10.76**	8.02**	4.67**
Adjusted R^2	0.272	0.373	0.595

** 5% level; * 10% level. F-value tests the joint hypothesis that all regression coefficients equal zero.

Focus first on the liquidity-related factors. Model 1 presents the baseline model without geographical controls, and Model 2 estimates Model 1 for the post-1996 reporting reform period only. The two models provide evidence that liquidity impacts the net discount that foreign investors receive. In Models 1 and 2, the coefficients on the natural log of the market capitalization and the natural log of the offering amount to market capitalization ratio are positive (significant at the 5% confidence level). The greater the fraction of securities sold abroad and the larger the market capitalization of the issuer, the smaller is the net discount granted to foreign investors. The coefficients on the natural log of the market capitalization and the natural log of the offering amount to market capitalization ratio, however, are insignificant for the geographical control model (reported as Model 3) in Table 8.

In contrast, the models reported in Table 8 provide mixed evidence on the hypothesis that the net discount represents compensation to foreign investors for the mispricing risk they bear. On the one hand, no evidence exists that foreign investors require an increased discount for the diminished level of U.S. regulatory protections they receive for the offering. The coefficients on the dummy variable for a securities fraud action are positive in all the models (and significant at

only the 20% level in Model 1 and at the 5% level in Model 3). If anything, therefore, the presence of a securities fraud action results in a *reduced* discount for foreign investors. The reduced discount supports the alternative hypothesis that the presence of a fraud suit indicates that the issuer is leaving the U.S. regime to reduce the risk of frivolous litigation and not to defraud foreign investors.[194] Likewise, the coefficient on SIC Code 357 (Computer and Office Equipment) is positive in all three models, although significant at only the 20% level in Model 3 and insignificant in Models 1 and 2. Issuers from SIC Code 357 tend to receive a lower net offering discount.

Note also that the coefficient on the market capitalization of the issuer is both positive and significant at the 5% level in all Models 1 and 2 (although insignificant in Model 3). As discussed above, a larger market capitalization may correlate with increased overseas liquidity for foreign investors, resulting in a reduced offering discount. Issuers with significant market capitalization may also present foreign investors with a diminished mispricing risk to the extent that more analysts follow the activities of larger market capitalization issuers. The positive coefficient on the issuer's market capitalization is consistent with both possibilities.

Finally, Table 8 reports evidence that issuers conducting a Regulation S offering in situations where the risk of managerial opportunism is higher may correlate with an increased net discount. On the one hand, greater director and officer beneficial share ownership leads to a diminished discount. The coefficients on the fraction of common stock owned by directors and officers are positive and significant at the 10% level in Model 1 and the 5% level in Models 2 and 3. Greater insider holdings of common stock result in a greater cost to management from engaging in self-dealing. The net discount, as a result, is reduced for issuers with greater insider holdings. As well, the coefficient on the fraction of the board comprised of officers of the issuer is negative and significant at the 5% level in Model 3 (insignificant in Models 1 and 2, however). The larger the fraction of insiders on the board of directors, the greater is the likelihood that the issuer

194. *See supra* note 182 (describing the theory that issuers may face lawsuits not driven by merit but rather by the desire of plaintiff's attorneys to extract a settlement); *see also* Choi, *supra* note 127 (providing evidence that U.S. issuers seek to conduct a Regulation S offering to avoid the high cost of frivolous suits inside the United States).

may engage in insider self-dealing, leading to a larger net discount as a result.[195]

A possible nonlinearity, however, may exist in the relationship between the common stock beneficial ownership of directors and officers and the net discount.[196] In particular, increased director and officer share ownership at lower absolute levels of ownership may lessen the vulnerability to insiders from shareholder complaints, leading to a raised incentive to engage in insider self-dealing and a greater net discount as a result. On the other hand, increased director and officer share ownership at higher absolute levels of ownership cause insiders to bear a greater fraction of the cost from actions that dilute the value of pre-offering shareholders, resulting in a reduced net discount. To control for this possibility, Model 2 in Table 8 is reestimated with the addition of a squared term for the director and officer beneficial share ownership. Not reported, the coefficient on the director and officer ownership variable is negative but statistically insignificant, while the coefficient on the squared term is positive and significant at only the 20% level in the control model. The control model's results, therefore, are only weakly consistent with the hypothesis that at lower levels of share ownership, management engages in greater self-dealing activities through Regulation S offerings while at higher levels, managers are deterred from self-dealing through the dilution they incur on their own share ownership.

Where the Regulation S purchasers obtain a board seat as part of the offering, they are also able to negotiate a larger discount. The coefficients on the dummy variable for the purchase of a board seat is negative in all three models and is significant at the 10% level in Models 1 for the entire sample and at the 5% level in Models 2 and 3 for the post–reporting reform period. The purchase of a board seat may indicate that the purchaser and the issuer's managers are engaged in self-dealing. For example, the purchaser may act as the managers' agent, supporting the managers' position in all board meetings in return for a discounted price on their Regulation S shares. The new board seat may also signal that the purchaser intends to provide valu-

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195. Even where boards are more "independent," several commentators have voiced doubt about the ability of the board of directors to monitor the actions of managers. *See* Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 898-903, 914-17 (1996).

196. *Cf.* Randall Morck et al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. FIN. ECON. 293, 311-14 (1988) (providing evidence for a nonlinear relationship between management ownership and the stock market valuation of a firm).

able monitoring services for which the purchaser is receiving compensation through a discounted Regulation S offering price.[197] On the other hand, the coefficient on the dummy variable for a reported sale to an insider, insider affiliate, or block shareholder is statistically insignificant in Model 1. Managers, nevertheless, seeking to engage in opportunistic self-dealing, may choose not to report such a sale.[198] The insignificant coefficient on the reported insider sale variable, therefore, does not necessarily provide evidence against the managerial opportunism hypothesis. Models 2 and 3, as well, dropped the dummy variable for a reported sale to an insider, insider affiliate, or block shareholder, due to lack of data.

Finally, the geographical-region dummy variables reported in Model 3 indicate that foreign investors price Regulation S securities differently depending on the jurisdiction of the offering. Securities offerings to Asia, Canada, and Central/South America receive a greater discount compared to sales to Europe. The coefficient on the Asia dummy variable is negative and significant at the 5% level; the coefficients on the Canada and Central/South America dummy variables, however, are statistically insignificant. On the other hand, the coefficient on the dummy variable for the "Other" region (including Africa) is positive and significant at the 5% level in Model 3. Offerings to the "Other" region receive a reduced discount compared with Europe.[199]

In summary, this Article's empirical test provides limited evidence that the net offering discount foreign investors obtain depends on three key factors: (1) the illiquidity risk the investors bear during the forty-day restricted period, (2) the risk to the foreign investors of purchasing overvalued securities from the issuer, and (3) the incentive of insiders to use Regulation S offerings to engage in self-dealing. In addition, the geographical region in which the offering takes place affects the mean offering discount.

197. For example, the purchaser may monitor managers to align their incentives with the general shareholders.

198. Item 701 of Regulation S-K does not mandate the disclosure of the purchaser's specific identity in a Regulation S offering. Issuers need only disclose the "class" of purchasers. *See* 17 C.F.R. § 229.701 (2000); *see also infra* notes 221-21 and accompanying text (providing examples of companies making only very general references to their class of purchasers).

199. As a further control, Model 2 of Table 8 was re-estimated with the addition of year dummy variables. None of the year dummy variables, however, was statistically significant.

IV. Policy Consequences

Regulation S offerings may inflict two distinct harms on U.S. investors. First, managers may employ a Regulation S offering to sell overvalued securities indirectly into U.S. markets, resulting in a transfer of value from U.S. purchasers to both the issuer and foreign investors acting as conduits for the issuer.[200] Second, managers acting purely out of self-interest may make a discounted Regulation S offering to entities in which they have an ownership interest; managers may also sell discounted securities to a block shareholder in return for that shareholder's continued support of management's self-interested activities. Alternatively, managers may attempt to raise a suboptimal level of capital.[201] Through such opportunistic behavior, managers are able to transfer value from the pre-offering shareholders of the issuer to themselves.

Nevertheless, not all Regulation S offerings pose either the threat of overvalued securities or managerial opportunism to U.S. investors. Similarly, not all Regulation S offerings that involve a large discount to the U.S. secondary market price harm U.S. investors. A large Regulation S offering discount, for instance, may be due to liquidity factors or the risk that foreign investors face of mispricing securities from the issuer.

Despite the specific nature of the dangers facing U.S. investors, the SEC chose in 1998 to pursue a set of untailored reforms designed to tighten the Regulation S exemption for all U.S. issuers. The direct prohibitions against resales into the United States for a one-year holding period combined with the various certification, legending, and stop-transfer requirements certainly work to discourage overvalued resales into the United States.[202] A considerable amount of new information on an issuer may emerge during one year; furthermore, any previously confidential information may be released during the year. Foreign investors, therefore, will be unlikely to maintain any informational advantage over the market after the one-year waiting period. Insiders may still gain from a heavily discounted Regulation S sale to entities in which they own an interest; waiting one year, however, increases the likelihood of detection as well as the liquidity risk

200. *See supra* Part II.A.2 (discussing the gain to the issuer from selling overvalued securities to U.S. purchasers through Regulation S).

201. *See supra* Part II.B (discussing how insider opportunism may result in a Regulation S offering to the detriment of U.S. investors).

202. *See supra* Part I (describing the restrictions on resales imposed through Regulation S).

insiders bear for that year, reducing the expected gain from self-dealing.[203]

On the other hand, the limitations on resale do not adversely affect managers that opportunistically raise capital to exploit for the managers' own purposes rather than to enhance shareholder welfare.[204] The harm from a suboptimal capital investment results from the initial sale to foreign investors and not from resales into the United States. Once securities are sold to foreign investors and capital transferred to the issuer, managers may divert the capital for their own purposes without regard to the one-year limitation on resales. Because the number of outstanding shares increases post-offering, U.S. investors are diluted regardless of whether the Regulation S shares ever enter the United States.

The reforms, moreover, also discourage all other types of Regulation S offerings including shareholder-wealth increasing offerings. A U.S. issuer, for instance, seeking to sell equity securities into a foreign country as part of a business expansion plan for the benefit of its shareholders must nevertheless comply with the offering restrictions and ensure that resales do not take place inside the United States for one year. At the very least, the restrictive nature of the present Regulation S raises the illiquidity risk foreign investors face and thereby the discount they will demand from U.S. issuers. The cost of capital to U.S. issuers, as a result, will increase. At the worst, such restrictions may completely eliminate foreign markets as a source of capital for U.S. companies. For instance, many foreign exchanges refuse to list securities legended with Regulation S resale restrictions, drastically reducing the ability of U.S. companies to conduct large foreign public offerings through Regulation S.[205]

This part explores several alternative policy responses for regulators that specifically address the risks a Regulation S offering poses to U.S. investors. Four possible reforms are identified that fit within the present securities regulatory framework: (a) information disclosure,

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203. *See* Jordan, *supra* note 34, at 113:

> A year provides more time for the market to realize that a stock is grossly overvalued; and when it does, the market and the short-sellers in it will expose the stock for what it is truly worth. A full year also allows more time for the SEC to spot an illegal manipulation in the works.

204. *See supra* Part II.B.2 (examining the incentive of managers to raise capital for their own private purposes).

205. *See, e.g.*, Beller, *supra* note 45, at 180-81 (describing the potentially high cost that the legending requirement of Regulation S imposes on issuers seeking to have their securities listed on a foreign exchange).

(b) differentiation by issuer, (c) differentiation by type of overseas offering, and (d) differentiation by geographical location of the Regulation S offering.

A. Information Disclosure

Increased information disclosure may reduce the potential harm that U.S. investors bear from both the overvaluation and managerial opportunism risks resulting from a Regulation S offering. The effect of information disclosure on both types of risks, nevertheless, differs.

1. *Disclosure and the Overvaluation Risk.* The overvaluation risk U.S. investors face depends on the informational advantage a company's managers enjoy over the U.S. secondary market in determining the value of the company's securities. The greater the informational advantage, the larger is the potential harm U.S. investors may suffer in purchasing overvalued securities.[206] Both the nature of any information disclosure associated with the Regulation S offering and the timing are important in determining the magnitude of this harm. Where issuers disclose all nonpublic information on the valuation of the company and do so in advance of any resales into the United States, U.S. investors face the least amount of overvaluation risk. Markets that react with 100% accuracy to news of a Regulation S offering, for instance, completely insulate U.S. investors from the risk of purchasing overvalued securities.[207]

Consider, however, the situation where less than full disclosure is made. An issuer, for instance, may simply disclose the existence of a Regulation S offering and nothing more. On average, nevertheless, the secondary market's reaction to this information should correctly assess the value of this information. For any given security, however, the market may either over- or underreact. As discussed above, where the market reacts with some degree of inaccuracy, issuers and foreign investors may still enjoy some opportunity to engage in the sale of overvalued securities into the United States.[208] Foreign investors may choose to resell securities into the United States, for exam-

206. A large informational advantage, for example, gives the issuer a greater ability to choose to sell securities only when the secondary market overvalues the securities.

207. *See supra* Part II.A.3 (discussing the impact to U.S. investors from Regulation S resales when the market reacts with 100% accuracy prior to the commencement of resales).

208. *See supra* Part II.A.4 (discussing the benefit from an informational advantage where the market reacts imperfectly to news of a Regulation S offering).

ple, only when the market underreacts to news of a Regulation S offering, leaving some amount of overvaluation in the market price.[209]

To lessen the informational advantage enjoyed by foreign investors reselling into the United States, regulators may therefore require issuers to disclose not only the existence of the Regulation S offering but additional information on the amount raised, the use of proceeds, and the identity of the purchasers.[210] In the alternative, regulators could treat foreign investors after a Regulation S offering as temporary insiders, allowing resales into the United States but only to the extent that the investors disclose any confidential information they received from the issuer to the U.S. secondary markets.[211]

In addition to the nature of the information disclosure on the Regulation S offering, the timing of the disclosure is also critical. Information disclosure after foreign investors successfully resell all their securities into the United States may increase the overall accuracy of securities pricing inside the United States; however, the disclosure will not protect U.S. investors purchasing the overvalued securities from the foreign investors. Any information disclosure regulation therefore must require timely disclosures ahead of any resales. Moreover, for securities that fail to trade in an efficient market,[212] dis-

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209. *But see supra* notes 105-06 and accompanying text (discussing how liquidity concerns may force foreign investors to resell into the United States even when the market overreacts to news of a Regulation S offering and results in an undervalued market price).

210. The present information disclosure items under Item 701 of Regulations S-K and S-B detail similar information items for a Regulation S offering. Item 701 of Regulation S-K, for example, requires disclosure of the offering date, the amount of securities, the total offering price, the use of proceeds, and the principal underwriters among other information. *See* 17 C.F.R. § 229.701 (2000). For a discussion of the SEC's recent attempts to increase the amount of information disclosure associated with a Regulation S offering, *see infra* notes 221-24 and accompanying text.

211. To the extent that foreign investors are located abroad, however, regulators may encounter difficulties in both collecting evidence that the investors held an informational advantage and enforcing any judgment against the investors. For a description of U.S. insider trading prohibitions, see Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 329-48 (1998).

212. Several versions of the efficient market hypothesis exist. The semi-strong version of the efficient capital markets hypothesis posits that the secondary market price of companies reflects all publicly available information on the company. *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970) (providing a survey of theoretical implications of efficient markets and empirical testing of the efficient markets hypothesis); *see also* Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud in the Market Theory*, 74 CORNELL L. REV. 907, 911 & n.9 ("The empirical evidence to date (with some exceptions) appears to establish the validity of the weak and semi-strong versions but not the strong form of the efficient capital markets hypothesis."). The Article uses the term "efficient market" to refer to a trading market that displays features of a semi-strong efficient market.

closure to the market in general may not be sufficient. Instead, disclosure directly to U.S. purchasers may be required.

The SEC has endeavored to increase both the timeliness and the amount of information on Regulation S offerings available to the U.S. secondary markets. In 1996, the SEC imposed reporting requirements on Regulation S issuers.[213] Within fifteen days of the sale, issuers had to report information, as detailed under Item 701 of Regulation S-K, on the title and amount of securities sold, the date of the transaction, the name of the placement agent or underwriter, the amount of consideration received, among other items.[214] The relatively short fifteen-day disclosure requirement worked to reduce the informational advantage of foreign investors before resales could commence.

After December 31, 1998, however, the SEC stopped requiring the disclosure of Regulation S offerings in Form 8-K.[215] Instead, issuers may now wait until their next scheduled periodic information filing with the SEC.[216] For some issuers, a delay of up to one-quarter of a year may therefore result before the market receives information on the offering. The SEC has argued that the increased delay in informational disclosure imposes no additional cost on the U.S. markets. Because most foreign investors must now meet a one-year holding period prior to reselling into the United States, the post-1998 disclosure requirement still results in timely disclosure prior to the commencement of resales.[217]

The SEC's move toward less timely information disclosure nevertheless does impose a cost on U.S. markets. In particular, timely information disclosure and resale restrictions act as substitute means to protect U.S. investors. The longer the delay in information disclosure on the Regulation S offering, the greater is the restricted period

Others have argued that markets are not efficient because of investor irrationalities and cognitive limitations in processing information. *See* Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 853-54 (1992) (noting that some economists, concerned with an apparent inability to validate the efficiency model, have responded with alternative hypotheses such as "noise" pricing influences); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 648-50 (1995) (reporting skepticism on the part of financial economists on the validity of the efficient market hypothesis).

213. *See supra* notes 49-50 and accompanying text (describing the 1996 reporting reforms).

214. *See* 17 C.F.R. §§ 228.701, 249.368 (2000).

215. *See supra* note 50.

216. Both the quarterly Form 10-Q and annual Form 10-K filing requirements for Exchange Act–reporting companies presently mandate disclosure of Regulation S offerings. *See id.* §§ 249.308A, 249.310.

217. *See id.*

regulators need to impose on foreign investors. A greater restricted period, in turn, raises the illiquidity risk facing foreign investors and thereby results in a larger offering discount, harming issuers and their pre-offering shareholders through diminished capital costs. To the extent that a fifteen-day disclosure period sufficiently informs the market to eliminate the overvaluation risk facing U.S. investors, little need exists for a one-year restricted period and the corresponding large illiquidity penalty placed on foreign investors.[218]

2. *Disclosure and the Risk of Managerial Opportunism.* In contrast with the overvaluation risk, the danger of managerial opportunism, whether through self-dealing or a suboptimal capital investment, is reduced through a different type of information disclosure. First, the risk from managerial opportunism is not directly related to the general informational advantage managers possess over the U.S. secondary market. Managers could enjoy no better information on the overall valuation of the issuer than the secondary market. Nevertheless, the managers will profit from a heavily discounted sale to entities in which they own an interest through Regulation S; managers may also benefit from the sale of discounted securities to a block shareholder that promises to return the favor through support of the managers' opportunistic activities. Likewise, managers without any informational advantage may choose to use the offering proceeds for their own private benefit at the expense of the issuer's shareholders.

Several legal prohibitions exist against such opportunism. At the level of state law, managers that use Regulation S to self-deal in heavily discounted securities or engage in suboptimal capital investment violate their fiduciary duty to their companies and to the pre-offering shareholders.[219] Under federal securities laws, managers may contravene insider trading restrictions to the extent that they resell the Regulation S securities at a profit while still in the possession of

218. For another argument that no need exists to extend the Regulation S restricted period past 40 days, see Hanks, *supra* note 7, at 328:

> In modern securities markets, decisions are made on a shorter term than forty days. Investments today are made on a fluid basis, and the holder of securities experiences far greater risk in a few days than would have been experienced over forty days several decades ago. In addition, distributions of securities come to rest in a much shorter period than in earlier decades.

219. *See* Cooter & Freedman, *supra* note 60, at 1053 (describing the duty of loyalty).

nonpublic information.[220] However, the effectiveness of these prohibitions depends on uncovering the connection of managers to the foreign entities engaging in the Regulation S purchases in the case of self-dealing, or alternatively, the use of proceeds for suboptimal capital investments.

Presently, the disclosure required under Item 701 of Regulation S-K does not require the disclosure of specific purchaser identities. Issuers may choose instead to disclose the "class" of purchasers.[221] For example, Sims Communications Inc. identified purchasers of its Regulation S offering in 1997 as "two foreign investment funds."[222] Preferred Voice, Inc., similarly, identified purchasers of its Regulation S offering as "three private foreign investors."[223] Alternatively, the issuer may disclose a specific purchaser's identity, but not the underlying relationship between the purchaser and a corporate insider. Insiders, for example, may use offshore dummy shell corporations to conceal their interest in the purchasers of a Regulation S offering. To combat problems of identification, regulators may wish to focus on disclosures targeted at revealing the specific identities of the purchasers of a Regulation S offering and, to the extent that the purchasers are not individuals, the ownership of the purchasing entities. U.S. regulators also could cooperate with regulators in other countries to determine the identity of Regulation S purchasers.[224]

Similarly, more detailed disclosure on the use of proceeds may lessen the risk of suboptimal capital investment to the extent that managers face an increased risk of a fiduciary duty suit based on the disclosure. Initially, Item 701 of Regulation S-K did not require the disclosure of the use of proceeds for Regulation S offerings. In 1997, the SEC amended Item 701 to require the disclosure of the use of

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220. *See* Fried, *supra* note 211, at 329-48 (describing the prohibitions under U.S. securities laws against insider trading).

221. *See* 17 C.F.R. § 229.701(b).

222. *See* Sims Communications Inc., *8-K Filing* (Nov. 5, 1997), *available at* http://www.freeedgar.com (on file with the *Duke Law Journal*).

223. *See* Preferred Voice, Inc., *8-K Filing* (July 10, 1997), *available at* http://www.freeedgar.com (on file with the *Duke Law Journal*).

224. The United States already has entered into a series of memoranda of understanding agreements with other countries that provide for information sharing and assistance in enforcing antifraud prohibitions across international borders. *See* Joel P. Trachtman, *Unilateralism, Bilateralism, Regionalism, Multilateralism, and Functionalism: A Comparison with Reference to Securities Regulation*, 4 TRANSNAT'L L. & CONTEMP. PROBS. 69, 89 (1994); *see also* James A. Kehoe, *Exporting Insider Trading Laws: The Enforcement of U.S. Insider Trading Laws Internationally*, 9 EMORY INT'L L. REV. 345, 359-62 (1995) (discussing the use of a memorandum of understanding in the area of insider trading).

proceeds.[225] Despite the amended Item 701, issuers may still disclose their intended use of proceeds in only very general terms. For example, Foodvision.com, Inc. conducted a Regulation S offering in 2000 to "thirty foreign persons" and reported that it planned to use its proceeds to fund "the Company's operations during the quarter."[226] As an alternative, regulators could require follow-up disclosures a specified time period after the offering from issuers indicating the actual use of proceeds.

At one level, the timing of the disclosure concerning the purchaser identity or the use of proceeds aimed at combating managerial opportunistic use of Regulation S does not matter. Even where disclosure occurs after foreign entities engage in resales into the United States, information on insider self-dealing or suboptimal capital investment will still enable pre-offering shareholders and the SEC to pursue legal action against the company's management. Management that expects such a legal response, as a result, will have a reduced incentive to act opportunistically in the first instance.

Timely disclosure may nonetheless work to protect U.S. investors. Even where the secondary market price is not overvalued pre-offering, the very offering itself may result in a overvalued market price post-offering. Where managers divert corporate wealth to their own accounts through self-dealing or suboptimal capital investments, for instance, the per-share fundamental value of the company necessarily drops.[227] U.S. investors, therefore, again face the risk of purchasing overvalued securities, even where the securities were not overvalued pre-offering. Rapid disclosure provides a means of protecting U.S. investors from this additional overvaluation risk.

B. Differentiation by Issuer

The significance of information disclosure provides another policy lever for regulators to consider: the type of issuer conducting the Regulation S offering. In particular, issuers with varying levels of market capitalization may pose different risks to U.S. investors. Investors possess numerous sources of information on large market capitalization companies. A number of professional securities analysts

225. *See* 17 C.F.R. § 229.701(f); 62 Fed. Reg. 39,755 (1997).

226. Foodvision Com, Inc., *Form 10-Q* (May 18, 2000), *available at* http://www.freeedgar.com (on file with the *Duke Law Journal*).

227. *See supra* Part II.B (describing the impact on shareholder welfare from managerial opportunism).

may closely track companies with a relatively large market capitalization.[228] These analysts may have direct contact with company management, information from the company's suppliers and customers, and detailed research on the company's competitors. In addition, Exchange Act–reporting companies, of which large market capitalization companies make up a large subset,[229] provide the market with periodic disclosures on the company's financials, management, business, and capital needs, among other things, through filings with the SEC.[230]

The informational advantage managers and foreign investors may enjoy over the U.S. secondary market, therefore, is reduced for the larger market capitalization issuers. Consequently, the degree of overvaluation risk U.S. investors face from a Regulation S offering is also reduced, regardless of any specific disclosure related to the offering the issuer makes to the market. Even where the issuer fails to disclose its Regulation S offering, because many financial institutions are multinational, news of the offering may also find its way into the United States for companies that the institutions track. If a broker for Goldman Sachs learns of the existence of privately placed Xerox securities in Germany, for example, information on this offering may find its way back to New York–based Goldman Sachs analysts following Xerox.[231] In addition, analysts will help transmit new information to investors and other market participants. Analysts may engage in arbitrage transactions, using their informational knowledge to trade securities. The trades, in turn, will provide a signal to others in the market about the analysts' information. Analyst-driven arbitrage trades will also reduce any deviations in the secondary market price from the company's fundamental value due to the price pressure resulting from a large influx of Regulation S resales into the United States.[232]

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228. *See supra* note 48 (discussing the "Aircraft Carrier" releases definition of a Form B issuer).

229. Analysts follow only a relatively small subset of Exchange Act–reporting companies. *See* COX ET AL., *supra* note 48, at 41.

230. Exchange Act–reporting companies must periodically disclose information on their business and property, *see* 17 C.F.R. § 229.101, and provide financial data to investors, *see id.* § 229.301-2. In addition, among other items, Exchange Act–reporting companies must periodically provide information on their directors and executive officers, *see id.* § 229.401-2, and on executive compensation, *see id.* § 229.402.

231. *See supra* note 88 and accompanying text.

232. *See supra* notes 95-99 and accompanying text (discussing the possibility of price pressure due to the large increase in the supply of an issuer's securities after resales of securities issued pursuant to Regulation S commence).

At the other end of the spectrum are companies with a relatively low market capitalization. Rather than trade on an established exchange, such smaller companies typically trade, if at all, on the over-the-counter "pink sheets" market in the United States.[233] Due to the small market capitalization, few analysts follow such companies, because the amount of possible trading profit does not justify the fixed cost of research. Investors in the securities of small capitalization issuers, therefore, must typically conduct their own research and cannot rely on the secondary market price to reflect accurately all publicly available information on the company.[234] Because many of the small capitalization issuers are also not Exchange Act–reporting companies, the market will not enjoy the informational benefits from the periodic disclosure requirements. Investors, for example, may not have up-to-date and audited financials. Little information may also exist on the issuer's line of business or the management of the issuer.[235] As a result, U.S. investors will face a relatively larger informational disadvantage relative to the management of an issuer for smaller capitalization companies. Even where regulators force specific informational disclosure on news related to the Regulation S offering, the secondary market price may react both slowly and with a great degree of inaccuracy in assessing the value of the company.

The differences in information available on large market capitalization and relatively unknown, smaller capitalized issuers provide regulators a means of improving upon the present Regulation S. Significantly, the original Regulation S promulgated in 1990 did make such a distinction among issuers.[236] Exchange Act–reporting companies under the original Regulation S were subject to less stringent requirements in conducting a Regulation S equity offering, avoiding the

233. *See* 3 HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 1.134 (2d ed. 2000) (describing the over-the-counter securities market as "a group of markets in which broker-dealers transact business with the public as principals or agents, dealing for the most part in securities not listed on any exchanges"); 3D *id*. § 23.10 (providing a description of the pink sheets market).

234. *Cf*. Binder v. Gillespie, 184 F.3d 1059, 1064-65 (9th Cir. 1999) (upholding the district court's determination that evidence on the presence of market makers and arbitrageurs for securities that trade only on the "pink sheets" over-the-counter market is not enough to deem the market efficient as a matter of law).

235. *See supra* note 230 (describing various information items that Exchange Act–reporting companies must periodically disclose to the SEC and to the public securities markets).

236. *See supra* note 30 and accompanying text (reporting the SEC's rationale behind distinguishing among Exchange Act and non-Exchange Act–reporting companies in the original Regulation S). *See generally* Lander, *supra* note 1 (providing a summary of the original Regulation S).

certification, legending, and stop-transfer requirements of the present Regulation S.[237] In reforming Regulation S in 1998, the SEC did away with almost all distinctions among issuers, despite the varying risks posed.[238]

Targeting specific regulatory efforts at those issuers that pose the greatest risk to U.S. investors both conserves scarce regulatory resources and results in better protection for U.S. investors than treating all issuers alike. To the extent that smaller market capitalization issuers pose the largest danger to U.S. investors, Regulation S should impose relatively greater restrictions on such issuers. Regulators may consider using Exchange Act reporting status as a proxy for the amount of information the market possesses on any particular issuer; in the alternative, regulators could use a more restrictive definition focusing on the larger market capitalization companies only.[239] In either case, regulators should act to relax both the restricted period and the offering and transactional requirements for companies on which the market already possesses a large supply of information.

The SEC may argue that the Exchange Act reporting status for issuers under Regulation S is irrelevant because the registration requirements under the Securities Act already make a similar distinction.[240] In particular, should the SEC move successfully toward company registration, larger, more well-followed issuers will have an easier and lower-cost alternative to Regulation S; larger market capitalization issuers may simply register their company and never face subsequent registration requirements when they issue new securities.[241] Foreign investors may then freely engage in resales into the

237. *See* Original Regulation S, 17 C.F.R. § 230.903(c)(2) (1990) (providing Exchange Act–reporting issuers offering equity through Regulation S the ability to do so without complying with certification, legending, or stop-transfer requirements).

238. *See supra* notes 42-44 and accompanying text (discussing how the SEC's 1998 reforms removed many distinctions between Exchange Act–reporting issuers and other companies under Regulation S).

239. *See supra* note 48 and accompanying text.

240. Under the Securities Act, for example, issuers conducting a registered offering may file a registration statement under Forms S-2 or S-3 instead of Form S-1 depending on, among other factors, the net non-affiliated public float of the issuer's securities in the market. *See* 17 C.F.R. § 239.12-13 (2000). Forms S-2 and S-3, in turn, provide issuers with the ability to incorporate information by reference from previously filed Exchange Act–reporting documents. *See id*.

241. Most recently, the SEC's Advisory Committee on Capital Formation issued a report in 1996 recommending a shift toward registering companies and not individual securities transactions. *See* Report of the Advisory Committee on the Capital Formation and Regulatory Processes, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,834, at 88,403 (July 24, 1996). In 1998, the SEC issued its sweeping "Aircraft Carrier" release that proposed a partial implementation of company registration through relaxed information disclosure and gun-jumping

United States immediately after the offering. Company registration, however, suffers from at least one major flaw compared with Regulation S. Company registration or, indeed, any simplified registration procedure for large market capitalization issuers, locks U.S. issuers into the U.S. securities regulatory regime even when issuing securities abroad. In contrast, the premise of Regulation S lies in limiting the territorial reach of U.S. securities regulation. Regulation S, therefore, holds open the promise of some degree of securities regulatory choice for issuers.[242]

C. Differentiation by Type of Offering Abroad

Given the importance of resales into the United States for at least some of the risks facing U.S. investors from a Regulation S offering, regulators may also wish to examine the type of offering that takes place under Regulation S. In particular, the motivation and ability of foreign investors to resell into the United States prior to the U.S. secondary market reaction to the offering may depend on the type of offering. For comparison purposes, consider two extremes: (1) public offerings to a large number of investors abroad and (2) private placements to a limited number of investors.

First, where a Regulation S offering involves a large public offering abroad, the overvaluation and the insider opportunism risks are greatly diminished. Even where no foreign securities regulatory regime governs the overseas public offering, the sale of securities to a broad audience of foreign investors will necessarily require publicity on the part of the issuer to generate interest among the foreign inves-

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requirements for large, seasoned, and well-followed issuers. *See* The Regulation of Securities Offerings, Exchange Act Release No. 33-7606A, Fed. Sec. L. Rep. (CCH) ¶ 86, 108 (Nov. 13, 1998).

242. Several commentators have argued for greater choice for issuers in selecting the securities regime that applies to transactions in their securities. *See generally* Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998) (advocating a system under which investors and issuers may choose from among several competing regulatory regimes and arrive at an "optimal" level of securities regulation); Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1 (arguing that "disclosure choice in securities offerings promises to expand the methods and reduce the costs of capital formation by aligning disclosure . . . with actual investor information demands, not legislative or administrative assumptions"); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) (proposing a regulatory approach of "competitive federalism, under which firms select their securities regulator from among the fifty states and the District of Columbia, the SEC, or other nations"). *But see* Fox, *supra* note 71 (arguing against regulatory choice and instead advocating that the home country of an issuer should regulate the disclosure regime for the issuer regardless of where investors are located or transactions take place).

tors.[243] Through the action of multinational foreign intermediaries, information disclosed abroad will make its way into U.S. markets even without any formal disclosure into the United States.[244] In addition, to the extent that a large number of foreign investors purchase securities in the offering, the risk of resale into the United States is reduced. Compared to the situation where only a few investors purchase securities abroad, foreign investors in a public offering have the option to resell to one of the numerous other foreign investors familiar with the public offering. A public offering, therefore, raises the probability of an overseas liquid market for the issuer's securities.

Viable counterarguments to this reasoning may be made. To the extent that a larger amount of capital typically is raised through public offerings, managers will have a greater ability to siphon value away from the issuer's shareholders for the managers' own private needs through suboptimal capital investments. On the other hand, the greater amount of public information generated through an overseas public offering will alert both foreign investors and, through the activities of financial intermediaries, U.S. investors of the nature of the offering. To the extent that a high probability exists of a suboptimal capital investment, investors around the world will discount the price of the securities prior to the offering and pursue potential legal remedies against the managers.[245] Likewise, managers may attempt to make a sale of securities to themselves or related block shareholders at discounted prices using a public offering as "cover" for their transaction.[246] To the extent, however, that insiders must give all investors in a public offering abroad the same price,[247] they will also hesitate to give unrelated investors the same large discount.

Second, Regulation S issuers may conduct sales to a relatively small number of investors in a private offering. Such offerings present U.S. investors with a greater overvaluation and insider self-dealing

243. Without publicity, for example, few investors abroad will know of the securities offering and will fail to participate as a result.

244. *See supra* note 88 and accompanying text (describing the multinational contacts of Goldman Sachs).

245. *See supra* notes 219-18 and accompanying text (discussing possible legal remedies against managers).

246. For example, an entity in which managers own equity may be one of numerous participants in the public offering.

247. Issuers, of course, may attempt to give different investors a varying purchase price. Whether or not this practice is allowed depends on the securities regime of the jurisdiction in which the Regulation S securities are sold. As well, giving different investors a varying price may alert the market that insiders are engaged in self-dealing.

risk than public offerings abroad. Managers, for example, may use a private offering to engage in self-dealing. The small number of investors in the offering increases the probability that managers may successfully keep the offering a secret. Similarly, managers who believe that the issuer's securities are overvalued in the U.S. secondary market may use a small number of foreign investors in an attempt to resell securities quickly in the U.S. to take advantage of the overvaluation. The fewer the number of investors, the easier it is for managers to conduct negotiations on how to allocate the overvaluation surplus. Moreover, a lower likelihood exists that information of the offering will filter its way into the United States prior to the commencement of resales. Managers may also transmit confidential information on the issuer's valuation to foreign investors when only a small number of investors are involved, increasing the risk that the foreign investors may enjoy an information advantage over the market even after news of the Regulation S offering is disclosed.[248]

Regulation S may therefore benefit from greater differentiation based on the size and scope of the offshore offering. Significantly, the differentiation the Article proposes for Regulation S offerings is exactly the opposite of the distinction made for domestic public and private offerings under the securities laws.[249] Regulators may wish to reduce the limitations on resales as well as the different offering and transactional restrictions for U.S. issuers that sell to a *large* number of foreign investors abroad through Regulation S. Regulators could implement a bright-line cutoff for the number of purchasers above which issuers face fewer resales restrictions.[250] To the extent that both

248. *See supra* Part II.A.4 (discussing the harm to U.S. investors when the U.S. secondary market reacts imperfectly to news of a Regulation S offering and foreign investors with superior information resell only when the market continues to overvalue the securities). Where only a few investors are involved in the Regulation S offering, however, the investors may face large illiquidity and opportunity costs and thus engage in resales immediately into the United States even where they have information that the U.S. secondary market price undervalues the securities. *See supra* notes 105-05 and accompanying text.

249. The U.S. securities laws provide for detailed mandatory information disclosure, heightened antifraud liability, and a controlled selling process for broad domestic public offerings. *See supra* note 2 (detailing the registration process under U.S. securities laws). In contrast, domestic private placements to a smaller number of investors receive far less regulation. For an example of a particular private placement under the securities laws, see Regulation D, 17 C.F.R. § 230.501-08.

250. Rule 506 of the Securities Act implements a similar bright-line rule cutoff for the number of purchasers allowed under its safe harbor for a private placement transaction. *See* 17 C.F.R. § 230.506(b)(2)(i) (limiting issuers to no more than 35 "purchasers," excluding investors that qualify for "accredited investor" status). Significantly, whereas Rule 506 restricts issuers seeking to sell above the cutoff number of purchasers, this Article argues that increased overseas liquidity and informational disclosures call for a reduction in the restrictions facing issuers

the overvaluation and insider self-dealing risks to U.S. investors are reduced, lowering the Regulation S restrictions presents no harm to U.S. investors while decreasing the cost to issuers from such an offering. U.S. investors as a group are then benefited through the decreased costs of raising capital abroad.

D. Differentiation by Geographical Location of the Issue

U.S. regulations dealing with Regulation S offerings do not operate in a vacuum. In the case of an overseas offering, the securities regime of at least one other country will apply to the offering. The impact of the foreign securities regime, of course, depends on the specific requirements of the regime. Consider two opposite situations: (1) where the foreign regime imposes no barriers to fraud or self-dealing and (2) where the foreign regime applies similar requirements as the U.S. regime dealing with information disclosure and routing out managerial opportunism.

In situations where the foreign regime does not regulate securities offerings, U.S. regulators may have a valid concern that U.S. issuers could use Regulation S to skirt U.S. regulatory prohibitions.[251] Contrast this to offerings into jurisdictions where the foreign regime is similar to the U.S. regime. For foreign regimes with a comparable regulatory regime, the argument for restricting resales of Regulation S securities into the United States becomes weaker. To the extent that issuers seek to sell overvalued securities abroad, they will face similar disclosure and antifraud prohibitions, deterring such action. Similarly, where managers seek to engage in insider self-dealing, foreign prohibitions will deter insiders. Indeed, the coefficients on the dummy variable for geographical location from Table 8 provide evidence that foreign investors take into consideration the region in which securities are offered in determining the offering discount. Offerings into countries located in Asia, Canada, and Central/South America, for example, tend to receive a greater discount than offerings into Europe.[252]

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that engage in a Regulation S offering involving above a specified minimum number of purchasers.

251. On the other hand, providing issuers an ability to choose for themselves the securities regime that applies to their offering may give issuers the ability to choose the set of protections that best protect investors while placing regulatory competitive forces on countries to tailor their regulations to maximize investor protection. *See infra* Part IV.B (discussing the possibility of issuer choice in securities regulation).

252. Only the coefficient on the dummy variable for Asia, however, is statistically significant. *See supra* notes 198-97 and accompanying text. Moreover, in the model for the net dis-

Foreign regulators, in seeking to enforce their securities regulatory regime on U.S. issuers, may face additional costs compared with U.S. regulators. At a minimum, foreign regulators will have an increased expense to gather information about the U.S. issuer.[253] In cases where the United States hinders enforcement of foreign judgments against U.S. issuers, foreign regulators may fail at deterring both securities fraud and insider self-dealing.

Regulators in the United States may wish to take into account the specific country in which the U.S. issuer is selling securities abroad in one of two ways. First, regulators may act to strengthen the securities regimes of other countries as applied to U.S. issuers. Through information exchange, U.S. regulators may assist foreign regulators in collecting information on fraudulent or self-dealing activities on the part of managers of U.S. companies. The United States, for example, already has a number of memoranda of understandings with different countries regarding insider trading investigations and enforcement.[254] Regulators may also require domestic issuers that sell securities abroad to agree to abide with enforcement actions and civil judgments from the foreign jurisdictions for actions stemming from the offering.

Second, U.S. regulators may also vary the requirements of Regulation S itself according to the foreign market in which the U.S. issuer conducts sales of its securities. U.S. securities regulators could make a substantive judgment that particular foreign regimes are similar to the U.S. regime and then decrease the restricted period for offerings to such jurisdictions and reduce the various transactional requirements.[255] Even where a foreign regime provides a lower level of protection than the U.S. regime, to the extent that the foreign re-

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count based on the expected secondary market reaction, none of the coefficients on the geographical region dummy variables are significant. *See* Appendix.

253. Note, however, that the Internet is reducing the cost of obtaining information on individual issuers. For example, investors around the world may simply go to http://www.fool.com for a variety of investor-related information on a large number of public companies.

254. *See supra* note 224 (describing the United States' efforts at cooperation with other countries' securities regulatory regimes through memoranda of understandings).

255. The United States already does take into account the securities regime of one particular country: Canada. In 1991, the SEC adopted a multijurisdictional disclosure system for qualified securities transactions involving a Canadian issuer into the United States. *See* Exchange Act Release No. 6902, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,812, at 81,861 (June 21, 1991) [hereinafter Release No. 6902]. The multijurisdictional disclosure system allows Canadian issuers to register a securities offering under the Securities Act while complying with Canadian disclosure requirements to the extent that certain requirements are met including reconciliation with U.S. G.A.A.P. accounting. *See* Exchange Act Release No. 7004, 58 Fed. Reg. 35,367 (1993).

gime is nevertheless more stringent than other alternative jurisdictions, the risk of resale and insider self-dealing are concomitantly reduced. Regulators, therefore, may benefit both issuers and investors through a sliding-scale approach to regulation, imposing more stringent resales restrictions for Regulation S offerings only into regimes with relatively weaker securities regulatory protections.

Opponents may argue that U.S. regulators may find it too costly to monitor the securities regimes of other countries. However, Regulation S in part already recognizes the distinctions between different offshore markets. The SEC has labeled certain overseas markets as "designated overseas securities markets" for purposes of meeting the offshore transaction requirement of Regulation S for resales under Rule 904 of the Securities Act.[256] To the extent that U.S. regulators already coordinate with other regimes in monitoring information on insider self-dealing actions, the incremental cost of assessing the level of investor protection provided through other regimes is reduced.[257]

V. CONCLUSION

This Article analyzes the risks U.S. investors confront from the use by domestic issuers of Regulation S to sell securities overseas. On a theoretical level, the Article argues that U.S. investors face risks from both the resale of overvalued securities into the U.S. market and the opportunistic use of Regulation S by managers to engage in self-dealing or suboptimal capital investment. The SEC's 1996 reporting reform greatly reduced the risk of overvaluation resales.[258] As a result, assessing the magnitude of the managerial opportunism risk assumes a more critical significance following the reporting reform.

Looking to empirical data, this Article presents evidence that insider self-dealing may partially drive the Regulation S offering discount. Regulation S therefore may pose a risk to U.S. investors even after the 1996 reporting reform. Evidence also exists that the discount for Regulation S offerings may be attributed to the need to compensate foreign investors for the illiquidity they bear during the Regula-

256. *See* 17 C.F.R. § 230.902(h)(1)(ii)(B)(2). Rule 902(b), in turn, lists a number of designated offshore securities markets including the London Stock Exchange, the Tokyo Stock Exchange, and the Toronto Stock Exchange among others. *See id.* § 230.902(b).

257. *See supra* note 224.

258. Note, however, that the SEC's 1998 Reforms increased the delay before issuers must disclose information on Regulation S offerings. *See supra* notes 213-14 and accompanying text (describing the SEC's evolving requirement for issuers to disclose information on Regulation S offerings).

tion S restricted period as well as the risk foreign investors bear of mispricing securities purchased from issuers.

Despite the continued risk of managerial opportunism, the SEC's subsequent 1998 reforms both provide an untailored response to opportunism and unnecessarily raise the cost of mitigating the separate overvaluation risk. This Article instead recommends a more narrowly tailored approach to combat the perceived risks facing U.S. investors from a Regulation S offering. Rather than focusing specifically on resales in the United States and extending the restricted period during which resales may not occur, this Article argues that regulators should instead turn to alternative regulatory devices.

Timely disclosure of information on the Regulation S offering, including specific purchaser identities and more detailed information on the use of proceeds, for example, may be sufficient to combat the possible overvaluation and insider opportunism risk to U.S. investors from the offering. To the extent that disclosure protects U.S. investors, regulators may then impose a shortened restricted period, reducing the illiquidity premium issuers must transfer to foreign investors. Regulators may also wish to differentiate based on the type of issuer, the size of the overseas offering, and the geographical region of the offering. Taking a more targeted approach to regulating Regulation S offerings allows offerings with a diminished risk of investor abuse to utilize foreign capital sources at a lower cost of capital, to the overall benefit of all U.S. investors.

APPENDIX

The appendix provides an alternative specification of the net offering discount offshore investors receive based on the expected secondary market reaction to the offering determined at the time the offering discount is negotiated. To generate the expected secondary market reaction, the appendix first estimates an ordinary least squares model for the eight-week cumulative excess return. The model of the eight-week CER includes five different types of independent variables.

$$CER = \alpha + X_1\beta_1 + X_2\beta_2 + X_3\beta_3 + X_4\beta_4 + X_5\beta_5 + \varepsilon$$

X_1 – Informational Disadvantage Variables
X_2 – Overvaluation-Related Variables
X_3 – Managerial Incentive Variables
X_4 – Use of Proceeds Variables
X_5 – Control Variables

First, in X_1 the model includes the natural log of market capitalization as a measure for the informational disadvantage outside investors may find relative to management. Firms with a greater market capitalization will attract a larger analyst following, reducing the informational disadvantage of the market relative to insiders in the firm. The less the informational disadvantage, the less reaction the market will have to news of an offering.

Second, in X_2 the model includes the natural log of the offering amount to market capitalization ratio. The more overvalued managers believe the securities of the firm, the larger the quantity of securities managers will attempt to issue. The market will therefore interpret a larger securities offering as a greater signal that the issuer's securities are overvalued, leading to a more substantial market reaction.

Third, in X_3 the model includes the fraction of corporate officers on the board of directors and the fraction of shares beneficially owned by directors and officers. The more insiders on the board of directors, the greater ability managers will have to use an offering to increase their own wealth at the expense of shareholders, generating a more negative market reaction. Similarly, the more shares in the

hands of managers, the less likely that managers will conduct an offering that dilutes the value of the shares.

Fourth, in X_4 the model includes controls for the issuer's stated use of proceeds for the offering. The market may value an offering differently depending on the use of the offering. In particular, dummy variables for whether the offering proceeds will be used for general working capital, product development, capital expenditures, business expansion, acquisitions, repayment of debt, or balance sheet–related purposes are added to the model with general corporate purposes as the base case. Where multiple uses are stated, only the first use is recorded; where no mention is made of the use of proceeds, the offering is placed in the general corporate purposes category.

Finally, in X_5 the model includes a set of various control variables. The number of world contacts,[259] a dummy variable for whether the offered security is common stock, and a dummy variable for whether the offering is a Rule 144A–related Regulation S offering are included in the model.

Not reported, the model for the eight-week CER is estimated for the post-1996 reporting reform period only and had an adjusted R^2 of 0.035. The coefficients obtained from the eight-week CER model are used to predict the eight-week cumulative excess return for each Regulation S securities issue in the dataset. The net discount is then calculated as follows:

Net Discount = Offering Discount – Predicted 8-Week CER

Using the alternative calculation of the net discount, the appendix then refits the three models reported in Table 8. The table below reports the results of the three models:

259. *See supra* note 181 (describing how this Article calculates the number of world contacts for each Regulation S issuer).

Appendix Table:
OLS Model of the Net Discount Calculated Using Predicted Secondary Market Return

The net discount is defined as the offering discount minus the predicted eight-week cumulative excess return. A more negative net discount corresponds to a larger discount from the secondary market price. The net discount is calculated only for common stock offerings and issues convertible into common stock.

Independent Variables	Model A1: Base Model	Model A2: Post-Reporting Reform Only	Model A3: Post-Reporting Reform Only with Geographical Controls
Natural Log of Market Capitalization	0.050**	0.068**	0.027
	(4.407)	(4.257)	(0.670)
Natural Log of Offering Amount to Market Capitalization Ratio	0.145**	0.138**	0.079**
	(12.423)	(8.668)	(2.296)
Number of World Contacts	0.005**	0.005*	0.003
	(3.199)	(1.798)	(0.704)
Dummy Variable for Fraud	0.039	0.008	0.009
	(1.167)	(0.148)	(0.073)
Dummy for SIC 357	0.100*	0.108	0.003
	(1.720)	(1.412)	(0.025)
Fraction of the Board Composed of Corporate Officers	-0.142*	-0.105	-0.433
	(-1.851)	(-0.933)	(-1.358)
Fraction of Common Stock Beneficially Owned by Directors and Officers	0.104	0.318**	-0.028
	(1.388)	(2.614)	(-0.089)
Dummy Variable for Board Seat Purchase	0.022	-0.104	-0.044
	(0.172)	(-0.673)	(-0.237)
Dummy Variable for Reported Sale to Insider, Insider Affiliate, or Block Shareholder	-0.118	-0.316*	-0.492*
	(-0.950)	(-1.675)	(-1.848)
Dummy Variable for Common Stock	-0.178**	-0.199**	-0.065
	(-5.621)	(-4.442)	(-0.618)
Dummy Variable for 144A Offering	0.060	-0.004	0.205
	(1.059)	(-0.046)	(1.117)
Dummy Variable for Europe	.	.	Base
Dummy Variable for Asia	.	.	0.013
			(0.109)

Dummy Variable for Canada	.	.	-0.196 (-0.859)
Dummy Variable for Central/South America	.	.	-0.120 (-1.009)
Dummy Variable for Other	.	.	0.104 (0.393)
Constant	0.147** (2.357)	0.073 (0.888)	0.231 (0.954)
Observations	415	184	63
F-value	45.34**	23.30**	2.54**
Adjusted R^2	0.541	0.573	0.284

** 5% level; * 10% level. F-value tests the joint hypothesis that all regression coefficients equal zero.

Similar to the results in Table 8, the Appendix Table provides evidence that factors correlated with the incentive and ability of managers to engage in insider self-dealing correlate with a greater net offering discount. Note that in all three models the coefficient on the fraction of the board comprised of corporate officers is negative. The more insiders on the board, the greater is the net offering discount. The coefficient, however, is significant at only the 10% level in Model A1 and at the 20% level in Model A3; the coefficient is insignificant in Model A2.

The fraction of common stock owned by directors and officers is positive in Models A1 and A2 (significant at only the 20% level in Model A1 and at the 5% level in Model A2). More shares in the hands of directors and officers result in a greater dilution in value to managers from any self-dealing activities, reducing their incentive to engage in such activities. The positive coefficient in Models A1 and A2 are consistent with this hypothesis. In contrast, the coefficient is negative and statistically insignificant in Model A3.

As discussed in the Article, the relationship of the share holdings of directors and officers with the offering discount may be nonlinear. At lower levels of ownership, incremental increases in share holdings may act to further entrench management and increase the level of managerial self-dealing, leading to larger net discounts. To control for this possibility, Model A2 is re-estimated with the addition of a squared term for the director and officer beneficial share ownership. In the control model, the coefficient on the director and officer ownership variable is negative and significant at the 10% level while the coefficient on the squared term is positive and significant at the 5%

level. The control model's results, therefore, are consistent with the hypothesis that at lower levels of share ownership, management engage in greater self-dealing activities through Regulation S offerings while at higher levels managers are deterred from self-dealing through the dilution they incur on their own share ownership.

Finally, note that the dummy variable for whether the issuer reported a sale to an insider, insider-affiliate, or block shareholder in the Regulation S offering is negative and significant at the 10% level in Models A2 and A3. A reported insider, insider-affiliate, or block shareholder share purchase therefore correlates with a greater offering discount. The greater offering discount is consistent with the hypothesis that insiders may use Regulation S to engage in self-dealing transactions at the expense of pre-offering shareholders.[260] Nevertheless, this Article cannot rule out the alternative hypothesis that large discounts given to a block shareholder in particular may act as compensation for the block shareholder's continued monitoring of management for the benefit of all shareholders.

260. As an additional control, Model 2 was re-estimated using year dummy variables. None of the year dummy variables were significant.