

SEC PROPOSES AMENDMENTS TO REGULATION M

The Securities and Exchange Commission (the “SEC”) recently issued a release (the “Release”) proposing amendments to Regulation M under the Securities Exchange Act of 1934, which governs the conduct of underwriters, issuers, and other parties with respect to securities offerings.¹ The proposed amendments, which are summarized below, update certain definitions and operative provisions to account for market developments since the adoption of Regulation M. In addition, the proposed amendments seek to enhance the transparency of syndicate covering bids and would prohibit the use of penalty bids and certain compensation arrangements affecting allocation of IPOs.

I. Overview of Regulation M

Regulation M currently consists of six rules relating to trading in connection with certain securities offerings. Rule 100 contains definitions of terms used in Regulation M. Rules 101 and 102 govern the activities of distribution participants and their affiliated purchasers and issuers, selling security holders, and their affiliated purchasers (collectively, “Covered Persons”), respectively, in connection with securities offerings. Rule 103 permits broker-dealers to engage in certain passive market making transactions with respect to Nasdaq securities during the applicable restricted period. Rule 104 restricts the use of stabilization, syndicate covering transactions, and penalty bids. Rule 105 prohibits covering certain short sales with offered securities purchased from an underwriter, broker, or dealer participating in an offering. The proposed amendments relate to Rules 100, 101, 102, and 104 and the adoption of a new Rule 106.

II. “Restricted Period” for IPOs

With a view to curbing opportunities to manipulate the open market price of a security which is the subject of a distribution, Rules 101 and 102 provide that during the “restricted period,” Covered Persons must refrain from directly or indirectly bidding for, purchasing, or attempting to induce any person to bid for or purchase the security being distributed. The SEC is proposing to amend the definition of the term “restricted period” in Rule 100(b) to provide a specific definition of that term as it relates to IPOs.

Currently, the length of the restricted period depends on the value of the relevant security’s average daily trading volume (“ADTV”) and the value of the issuer’s public float. The term “restricted period” with respect to a Covered Person is defined as:

¹ SEC Release No. 34-50831 (December 9, 2004).

- for securities with an ADTV value of \$100,000 or more of an issuer whose common equity securities have a public float value of \$25 million or more, the period beginning on the later of (a) one business day before the determination of the offering price or (b) the time that such person becomes a distribution participant and ending upon the person's completion of participation in the offering;
- generally, if either the ADTV value is less than \$100,000 or the issuer's public float is less than \$25 million, the period beginning on the later of (a) five business days before the pricing of the offering or (b) the time that such person becomes a distribution participant and ending upon the person's completion of participation in the offering; and
- in the case of a distribution relating to a merger, acquisition, or exchange offer, the period beginning on the day proxy solicitation or offering materials are first distributed to security holders and ending upon the completion of the distribution.

These restricted periods do not apply, however, to distribution participants and their affiliated purchasers with respect to covered securities² that have an ADTV value of at least \$1 million and are issued by an issuer whose common equity securities have a public float of at least \$150 million ("Actively-Traded Securities"). Issuers, selling security holders, and their affiliated purchasers are not subject to a restricted period with respect to reference securities that have an ADTV value of at least \$1 million and are issued by an issuer whose common equity securities have a public float of at least \$150 million ("Actively-Traded Reference Securities").

Currently, the absence of an existing trading market for initial public offering ("IPO") securities results in a restricted period for such securities that generally begins five days before determination of the offering price. The SEC proposes to add a new paragraph to the definition of restricted period to specify that, in the case of an IPO, the restricted period will begin: (a) on the earlier of the time when the issuer reaches an understanding with the broker-dealer that is to act as its underwriter or such time as a person becomes a distribution participant, or (b) if there is no underwriter, on the earlier of the time that the registration statement is filed with the SEC or other offering document is first circulated to potential investors or such time as a person becomes a distribution participant. The SEC is concerned about the manipulative potential of distribution participants arranging for IPO purchasers to make additional aftermarket purchases of the same securities. It is proposing to lengthen the restricted period for IPOs to address that problem.

In connection with the new restricted period for IPOs, the SEC is proposing to define IPO in Rule 100(b) to mean (a) an issuer's first offering of a security to the public in the United States, and (b) if an issuer's equity securities do not have a public float before the offering, the first offering of an equity security to the public in the United States. The Release states that this definition is intended to pick up an issuer's first offering in the United States and, if an issuer's first offering in the United States is a debt offering, the issuer's first equity offering in the United States.

² Rule 100 defines: (a) "covered securities" as any securities that are the subject of a distribution or any reference securities; and (b) "reference securities" as securities into which securities that are the subject of a distribution may be converted, exchanged, or exercised or which may, in whole or in significant part, determine the value of the security that is to be distributed.

III. Restricted Period for Corporate Actions

The SEC is also proposing to amend the definition of restricted period in Rule 100(b) to codify the SEC's long-standing tradition that the restricted period for mergers, acquisitions, and exchange offers includes valuation and election periods. The proposal also would define the term "valuation period" as any period during which the market price of the offered security is a factor in determining the consideration to be paid in the distribution. The term "election period" would be defined as any period during which shareholders have the right to elect among various forms of consideration offered in a distribution. The proposal would amend the definition of "restricted period" for mergers, acquisitions, and exchange offers to include both the period one or five business days (depending on the ADTV and public float values discussed above) before the commencement of any valuation or election period and such valuation or election period.

IV. Actively-Traded Security Exception: ADTV and Public Float Value Thresholds

The SEC is proposing to amend the ADTV and public float value thresholds, discussed above, to adjust them for the inflation that occurred between 1996 and 2004. During that time, the Consumer Price Index rose approximately 20 percent. The SEC proposal would increase the one-day restricted period values from \$100,000 to \$120,000 for ADTV and from \$25 million to \$30 million for public float. Similarly, the SEC would increase the Actively-Traded Securities and Actively-Traded Reference Securities thresholds from \$1 million to \$1.2 million for ADTV value and from \$150 million to \$180 million for public float value.

V. *De Minimis* Exception

The *de minimis* exception is designed to exclude small, inadvertent transactions from Rule 101's trading restrictions. This exception in Rule 101(b)(7) excepts (a) purchases during the restricted period, other than by a passive market maker, that total less than 2% of the ADTV of the security being purchased and (b) unaccepted bids. The provision requires the person making such bid or purchase to maintain and enforce written policies and procedures reasonably designed to achieve compliance with Regulation M. There is currently no requirement to inform the SEC of reliance on the exception. As a result, the SEC does not know how often the exception is used, whether certain firms repeatedly rely on the exception, or whether firms have adequate procedures to qualify them for the exception.

The proposed modification of Rule 101(b)(7) would require firms to create a separate record of each bid or purchase that is made in reliance on the *de minimis* exception. The record would have to include, among other things, the relevant security, the day the restricted period began, the ADTV, and the bids or purchases that would violate Regulation M were it not for the *de minimis* exception, including the time, price, quantity, and market of such bids or purchases. Finally, proposed Exchange Act Rule 17a-4(b)(13) would require brokers and dealers to maintain these records for a period of not less than three years and in an easily accessible place for the first two years.

VI. Syndicate Covering and Penalty Bids

A. Syndicate Covering Transactions

Rule 104 governs stabilization, syndicate covering transactions, and penalty bids³ and addresses the risk that these practices may create a false or misleading appearance with respect to the trading market for the offered security by supporting the aftermarket at prices around or above the offering price (in the case of penalty bids, by potentially discouraging immediate sales of IPO securities). Currently, Rule 104 imposes pricing, disclosure, and other conditions on stabilization. Since the adoption of Regulation M, the SEC has reviewed syndicate covering transactions and, as a result of its similarity to stabilization, the SEC is proposing to amend Rule 104 to require any person communicating a bid for the purpose of effecting a syndicate covering transaction to identify or designate the bid as such wherever it is communicated. The SEC stated that it will continue to monitor syndicate covering transactions to determine whether any other limitations on stabilization should be applied to syndicate covering transactions.

B. Penalty Bids Prohibited

The SEC proposes to amend Rule 104 to prohibit the use of penalty bids in connection with an offering and, consequently, to eliminate references to penalty bids in certain other rules. As stated above, the SEC believes that penalty bids can function as an undisclosed form of stabilization by preventing immediate sales of IPO securities. In addition, the SEC believes that sales representatives may improperly interfere with their customers' right to sell securities because of their fear of losing sales commissions. Finally, the SEC cited what it perceives as the discriminatory effects of penalty bids in that institutional salespersons, as opposed to retail salespersons, typically are not penalized when their customers flip their IPO securities.

In a significant related development, as described in our client memorandum of January 3, 2005, the NASD and the NYSE have proposed to allow penalty bids assessed on the entire syndicate as an exception to prohibitions on recouping discounts from broker-dealers whose customers "flip" shares bought in an IPO.⁴ The comment period for these NASD and NYSE rule proposals has

³ Rule 100 defines: (a) "stabilization" as the placing of a bid, or the effecting of a purchase, for the purpose of pegging, fixing, or maintaining the price of a security; (b) a "syndicate covering transaction" as the placing of any bid, or the effecting of any purchase, on behalf of the sole distributor or the underwriting syndicate or group to reduce a short position created in connection with the offering; and (c) a "penalty bid" as an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.

⁴ NASD proposed Rule 2712(c) and (d) and NYSE proposed Rule 470(C). Members and their associated persons would be prohibited directly or indirectly from recouping, or attempting to recoup, any portion of a commission or credit paid or awarded to an associated person for selling shares in an IPO that are subsequently flipped by a customer, unless the managing underwriter has assessed a penalty bid on the entire syndicate. In NASD proposed Rule 2712(d) and NYSE proposed Rule 470(F)(5) (which also cites NYSE Rule 472.120), "flipped" is defined to mean the initial sale of IPO shares purchased in an offering within 30 days following the offering date of such offering. "Penalty bid" is defined in NASD proposed

been extended to February 15, 2005, which coincides with the comment period for the SEC's Regulation M proposal discussed herein.⁵

VII. Exception for Transactions in Rule 144A Securities

Rule 104(j)(2) excepts from the Rule 104 limitations certain transactions in Rule 144A securities offered and sold in the United States.⁶ The Release states that, when adopting Regulation M, the SEC intended to make this exception from Rule 104 identical to the exception for Rule 144A securities under Rules 101 and 102. Accordingly, the SEC proposes to amend Rule 104(j)(2) to clarify that the exception from Rule 104's restrictions on stabilizing activities applies not only to the securities that are eligible for Rule 144A but also to any reference security.

VIII. New Rule 106

The SEC proposal includes new Rule 106, which would prohibit, in connection with an allocation of an offered security, distribution participants, issuers, and their affiliated purchasers, directly or indirectly, from attempting to induce, inducing, soliciting, requiring, or accepting from a potential purchaser of the offered security any consideration in addition to that stated in the registration statement or applicable offering document for such security. For example, in connection with allocating an offered security, this rule would prohibit distribution participants from requiring that a potential purchaser also purchase another security to be sold or proposed to be offered or sold by such distribution participant. The SEC has also indicated that Rule 106 would apply to any securities distribution, whether a public offering or a private placement of securities and whether an initial or a secondary offering. The Release describes the SEC's belief that the conduct prohibited by this proposed rule, which often occurs during "hot issues" periods, undermines the ability of the securities markets to function as an independent pricing mechanism and damages investor confidence in the securities offering process generally.⁷

Rule 2712(d)(2) and NYSE proposed Rule 470(F)(6) to mean an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions. NYSE proposed Rule 470(F)(6) also cites the definition of penalty bid in Rule 100 of SEC Regulation M.

⁵ 70 Fed. Reg. 3,415 (Jan. 24, 2005).

⁶ The rule also provides that such Rule 144A securities must be offered or sold only to qualified institutional buyers in a transaction that is exempt from registration under the Securities Act of 1933 or to non-U.S. persons during such distribution to qualified institutional buyers.

⁷ Note, however, that the Release also states the SEC's view that "the proposed rule is not intended to interfere with legitimate customer relationships." Thus, Rule 106 is not intended to prohibit a firm from allocating IPO shares to a customer because that customer has separately retained the firm for other services, to the extent that the customer has not paid excessive compensation for such other services.

IX. Comment Period

The SEC is soliciting comments on the proposed rules through and including February 15, 2005.

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If you have any questions concerning the foregoing or would like further information, please call Roger D. Blanc at (212) 728-8206, Martin Miller at (212) 728-8690, or the attorney with whom you regularly work.

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