THE SEC PROPOSES AMENDMENTS TO REGULATION M:
ANTI-MANIPULATION RULES CONCERNING SECURITIES OFFERINGS

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The Securities and Exchange Commission recently proposed amendments to Regulation M under the Securities Exchange Act of 1934 ("Exchange Act"), which governs the activities of underwriters, issuers, selling security holders, and distribution participants in connection with offerings of securities (the "Proposals").¹

The SEC states that the Proposals are primarily designed to prohibit certain activities by underwriters and other distribution participants that can potentially undermine the integrity and fairness of the offering process. The Proposals also seek to enhance the transparency of syndicate covering bids and prohibit the use of penalty bids and are also intended to update certain definitional and operational provisions in light of market developments since Regulation M’s adoption. As a consequence of the proposed amendments to Regulation M, the SEC is also recommending corresponding changes to disclosure rules under the Securities Act of 1933 ("Securities Act"), as well as changes to certain recordkeeping rules under the Exchange Act. The Proposals would:

- amend the definition of “restricted period” as it relates to initial public offerings ("IPOs") to increase the length of the applicable “restricted period”;
- amend the definition of “restricted period” as it relates to mergers, acquisitions and exchange offers to include expressly valuation and election periods within the scope of the applicable “restricted period,” consistent with the Commission’s long-standing interpretation of such definition;
- amend Rules 100, 101, and 102 to update the average daily trading volume ("ADTV") value and public float value qualifying thresholds for purposes of the “restricted period” definition and the actively-traded securities and actively-traded reference securities exceptions;
- amend the “de minimus exception” set forth in Rule 101 to require recordkeeping regarding bids or purchases made in reliance on such exception;
- amend Rule 104 to require disclosure of syndicate covering bids and to prohibit penalty bids; and

¹ See SEC Release Nos. 33-8511; 34-50831; IC-26691 (December 9, 2004) (the “Proposing Release”).
• adopt new Rule 106 to expressly prohibit distribution participants, issuers, and their affiliated purchasers, directly or indirectly, from demanding, soliciting, attempting to induce, or accepting from their customers any consideration in addition to the stated offering price of the security.

The proposed amendments are open for public comment until February 15, 2005. We believe it is likely that the SEC will take definitive regulatory action based on the Proposals in the second quarter of 2005 and that reforms closely resembling the Proposals will be adopted in this timeframe. This memorandum comprises a summary highlighting the significant aspects of the Proposals.

PROPOSED AMENDMENTS TO RULE 100(B): DEFINITION OF “RESTRICTED PERIOD”

Increase Length of “Restricted Period“ for IPOs

Proposed amendment to Rule 100(b) would change the definition of “restricted period” as it relates to IPOs. During the restricted period, covered persons must refrain from directly or indirectly bidding for, purchasing, or attempting to induce any person from bidding for, or purchasing a covered security. In the current version of Regulation M, the restricted period for IPOs commences on the later of five business days prior to the determination of the offering price or at such time that a person becomes a distribution participant. The restricted period generally ends upon such person’s completion of participation in the distribution.

The Commission has determined, however, that in the case of IPOs, a maximum restricted period of five days may not adequately address potentially abusive and manipulative conduct. Because there is no pre-existing trading market that would provide an independent pricing mechanism for prospective investors to evaluate the IPO price set by underwriters, the

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2 A covered security is defined as any security that is “the subject of the distribution, or any reference security.” A reference security is defined as a “security into which a security that is the subject of a distribution (‘subject security’) may be converted, exchanged, or exercised or which, under the terms of the subject security, may in whole or in significant part determine the value of the subject security.”

3 Under the current version of Regulation M, the length of the restricted period is based on the value of the security’s average daily trading volume (“ADTV”) and the public float of the issuer’s common equity securities. Specifically, if a covered security has an ADTV value of $100,000 or more and the issuer’s common equity securities have a public float value of $25 million or more, the restricted period begins on the later of one business day prior to the determination of the offering price, or at such time that a person becomes a distribution participant. If a covered security’s average daily trading volume and public float values are less than $100,000 and $25 million, respectively, then the restricted period commences on the later of five business days prior to the determination of the offering price or at such time that a person becomes a distribution participant. As a result of the absence of a pre-existing trading market for the covered securities in the case of IPOs, a five-day rule has applied to IPOs.
SEC believes that any inducement activity by underwriters and other distribution participants can have long-lasting effects. The Commission believes that attempts to induce aftermarket bids or purchases are inappropriate at any time prior to the pricing and distribution of an IPO, and that such conduct that occurs earlier than five days before IPO pricing can inappropriately effect the pricing of an offering. As such, the Commission believes that a maximum five-day restricted period in the context of IPOs is inadequate to address potentially manipulative conduct in such offerings. Accordingly, the SEC is proposing to add a new paragraph to the Rule 100 definition of restricted period that provides that in the case of an IPO, the restricted period would commence at the earlier of: (1) the period beginning at the time an issuer reaches an understanding with a broker-dealer that is to act as an underwriter, or such time that a person becomes a distribution participant; or (2) if there is no underwriter, the period beginning at the time the registration statement is filed with the Commission or other offering document is first circulated to potential investors, or such time that a person becomes a distribution participant, and would conclude when the distribution is completed.

In addition, the Commission is proposing to define IPO in Rule 100(b) to mean (i) an issuer’s first offering of a security to the public in the United States, and (ii) if prior thereto the issuer’s equity securities do not have a public float value, an issuer’s first offering of an equity security to the public in the United States. The Commission notes that under this revised definition of IPO, if an issuer’s first offering of a security in the United States is an offering of debt securities, then both that debt offering and the issuer’s first offering of equity securities in the United States would fall within this proposed definition of IPO. However, if an offered security already has a trading market either domestically or abroad for which ADTV and public float values may be calculated, then the offering of equity securities would not be an IPO, and either a one or five-day restricted period would apply based on the ADTV and public float values. The Commission also noted that the actively-traded security or reference security exception would not apply to IPOs.

“Restricted Period” for Mergers, Acquisitions, and Exchange Offers

Proposed amendment to Rule 100(b) would amend the definition of “restricted period” with respect to mergers, acquisitions and exchange offers to include express provisions for valuation and election periods in the context of such transactions and add definitions for these terms. The SEC states that these periods have long been considered by the Commission to be included in the restricted period because they are deemed part of the distribution and because valuation and election periods are price-sensitive times during which the incentive for interested persons to manipulate is high. Currently, the Rule 100(b) definition of restricted period for mergers, acquisitions and exchange offers refers to “the period beginning on the day proxy solicitation or offering materials are first disseminated to security holders . . .” but the

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4 The proposed amendment defines valuation periods as time periods when the offered security’s market price is a factor in determining the consideration paid in a corporate action. Election periods are defined as time periods when shareholders have the right to elect among various forms of consideration.
rule text itself does not explicitly refer to valuation and election periods. The SEC believes that
a specific reference to valuation and election periods in the definition of restricted period in
Rule 100(b) would be beneficial.

PROPOSED AMENDMENTS TO RULES 100, 101, AND 102: INCREASE ADTV AND PUBLIC FLOAT
VALUE THRESHOLDS FOR THE RESTRICTED PERIOD DEFINITION AND THE ACTIVELY-TRADED
SECURITIES AND ACTIVELY-TRADED REFERENCE SECURITIES EXCEPTIONS

Rules 101 and 102 of Regulation M prohibit certain persons from making bids or
purchases during “restricted periods,” as defined in Rule 100(b). As discussed above, the
current applicable restricted period under Regulation M begins either one or five days before
determining the offering price depending on the security’s ADTV value and the issuer’s public
float value. Offerings of securities that have an ADTV value of at least $100,000 and were
issued by an issuer whose common equity securities have a public float value of at least $25
million are bound by a restricted period that commences one day prior to the day of the pricing
of the offering. Offerings of securities falling below these thresholds are currently subject to a
five-day restricted period. In addition, Rules 101(c)(1) and 102(d)(1) currently provide that
actively-traded securities and actively-traded reference securities, defined as those with an
ADTV value of at least $1 million and issued by an issuer whose common equity securities have
a public float value of at least $150 million, are excepted from the provisions of Rules 101 and
102 when such securities are not issued by the issuer, a distribution participant or an affiliate
thereof. In effect, there generally is no restricted period applicable to offerings of such
securities.

The Commission believes that as a result of inflation and decrease in the value of the
dollar since Regulation M’s adoption in 1996, the ADTV and public float value thresholds used
in Rule 100’s restricted period definition and the actively-traded security and actively-traded
reference security exceptions contained in Rules 101 and 102 have become less restrictive. In the
Proposing Release, the SEC indicates that because of inflation and the erosion of the value of the
dollar, more issuers’ securities now qualify for the one-day restricted period and the actively-
traded security and actively-traded reference security exceptions, and the lower thresholds may
except from Regulation M’s prohibitions securities that may be more susceptible to
manipulation, than the Commission originally contemplated.

The proposed amendments contemplate a 20 percent increase in the applicable
thresholds to adjust for inflation, as reflected in the 20 percent increase in the Consumer Price
Index (“CPI”) between the adoption of Regulation M in 1996 and 2004. Specifically, the
proposed amendments would adjust the threshold needed to qualify for the one-day restricted
period to at least $120,000 for ADTV value and $30 million for public float value, and would
adjust the thresholds needed to qualify for the actively-traded security and actively-traded
reference security thresholds to at least $1.2 million for ADTV value and $180 million for public
float value.
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<th>Current Thresholds</th>
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<td><strong>One-day “restricted period”</strong></td>
<td><strong>Proposed Thresholds</strong></td>
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<td>• ADTV value ≥ $100,000; and</td>
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<td>• Public float value ≥ $25 MM</td>
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<td><strong>Five-day “restricted period”</strong></td>
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**PROPOSED AMENDMENT TO RULE 101(b)(7): REQUIRING RECORDKEEPING CONCERNING TRANSACTIONS RELYING ON THE DE MINIMIS EXCEPTION**

The *de minimis* exception in Rule 101(b)(7) excuses from Rule 101’s trading prohibitions inadvertent purchases and unaccepted bids during the applicable restricted period that total less than two percent of the distributed security’s ADTV if the person making the bid or purchase maintains and enforces written policies and procedures reasonably designed to achieve compliance with Regulation M. The SEC has stated that repeated reliance on the exception by distribution participants or their affiliated persons has raised concerns about whether transactions falling under this exception were indeed “inadvertent” as well as questions regarding the adequacy and effectiveness of firms’ compliance policies and procedures. Therefore, the Commission is proposing to modify Rule 101(b)(7) to require firms to create a separate record of each bid or purchase that is made in reliance on the *de minimis* exception. The SEC believes that this requirement will allow the Commission and self-regulatory organizations to uncover patterns of abuse or policies or procedures that are not reasonably designed to achieve compliance with Regulation M.

**PROPOSED AMENDMENT TO RULE 104: DISCLOSURE OF SYNDICATE COVERING TRANSACTIONS AND PROHIBITION OF PENALTY BIDS**

*Syndicate Covering Transactions*

Syndicate covering transactions occur when the managing underwriter of an offering places a bid or effects a purchase on behalf of the underwriting syndicate in order to reduce a syndicate short position created in connection with the offering. Unlike stabilization transactions,⁵ which under Rule 104 require, among other things, prior notification to the market, under the current rules, syndicate covering transactions require only prior notification to the relevant self-regulatory organization.

⁵ “Stabilizing” is defined as “the placing of any bid, or the effecting of any purchase, for the purpose of pegging, fixing, or maintaining the price of a security.” 17 CFR 242.100(b).
In the Proposing Release, the SEC indicates that it is concerned that syndicate covering transactions may be used as a means to support post-offering market prices. Because syndicate covering transactions are not subject to the conditions that apply to stabilization transactions under Rule 104, including, in particular, the contemporaneous market disclosure of the bidding and purchasing activity, the Commission believes that this lack of transparency has the potential to create a false or misleading appearance with respect to the trading market for the offered security. In an effort to “enhance the transparency of syndicate covering transactions,” the Proposals would amend paragraph (h)(2) of Rule 104 to require a managing underwriter or other person communicating a bid that is for the purpose of effecting a syndicate covering transaction to identify or designate the bid as such wherever it is communicated.

The Commission notes in the Proposing Release that it is not at this time proposing to apply to syndicate covering bids the type of specific price, counter-party disclosure, or other limitations that now apply to stabilizing transactions. Instead, the Commission states that it will continue to monitor such transactions, and consider whether any additional regulation of syndicate covering transactions in the future is appropriate.

**Penalty Bids**

Penalty bids are a contractual term in agreements among underwriters that allow the managing or lead underwriter to reclaim a selling concession paid to a syndicate member if that member’s customer sells its allocated shares in the immediate aftermarket. Proposed amendment to Rule 104 would prohibit the use of penalty bids. The Commission states in the Proposing Release that it understands that penalty bids are rarely assessed, and are utilized most often in connection with offerings for which there is relatively low demand to help prevent triggering or exacerbating a market price decline through investor sales of IPO shares.

The Commission believes, however, that penalty bids raise three “troublesome issues.” First, because Rule 104 does not require the assessment of a penalty bid to be disclosed to the market, the SEC has stated that such bids can function as an undisclosed form of stabilization by discouraging immediate sales of IPO securities that would otherwise lower a stock’s market price. Second, because some sales representatives may fear losing a sales commission if their customers sell their IPO shares, the SEC believes that penalty bids may result in a salesperson’s improper interference with a customer’s right to sell securities when the customer chooses to do so. Finally, the SEC notes that the assessment of penalty bids at the syndicate level results in discriminatory effects on the syndicate member’s customers. For example, the Commission believes that institutional salespersons are not penalized when their institutional customers flip their shares, but retail salespersons are more likely to be penalized. The Commission notes that while internal compensation matters are not the focus of its proposed rule amendment, it is mindful that the pressure of a penalty bid assessment by a managing underwriter can result in discriminatory and improper conduct by a firm and its salespeople towards its customers.

Accordingly, the Proposal would add a new subparagraph under Rule 104, which would provide that, “it shall be unlawful to impose or assess any penalty bid in connection with an offering,” and eliminate the existing references to penalty bids in subparagraph (2) of the
Rule. The Commission notes that while it considered requiring disclosure of penalty bids by sales representatives to customers, it did not believe that such disclosure would address the conflicts that arise with respect to their use. The Commission also believes that such direct disclosure could be confusing or intimidating, and ultimately have an even greater chilling effect on those investors who wish to sell their shares in the aftermarket.

**PROPOSED AMENDMENT TO RULE 104(j)(2): TRANSACTIONS IN RULE 144A SECURITIES**

In the Proposing Release, the Commission proposes amendment to Rule 104(j)(2), which generally excepts from Rule 104 transactions Rule 144A securities offered and sold in the U.S., provided they are sold either to qualified institutional buyers in a transaction exempt from registration under the Securities Act or to non-U.S. persons in Regulation S offerings that are made concurrently with a Rule 144A offering. The SEC proposes to add the words “or any reference security” to Rule 104(j)(2) in order to make the subparagraph consistent with the same exception under Rules 101(b)(10) and 102(b)(7) for transactions in Rule 144A securities.

**PROPOSED NEW RULE 106: PROHIBITION OF TYING**

Proposed new Rule 106 would expressly prohibit distribution participants, issuers, and their affiliated purchasers, directly or indirectly, from demanding, soliciting, attempting to induce, or accepting from their customers any consideration in addition to the stated offering price of the security.

According to the Commission, this new rule:

would expressly prohibit certain abuses that occurred in connection with IPOs, particularly those in the late 1990’s and in other “hot issue” periods, such as conditioning or “tying” an allocation of shares in a “hot issue” on an understanding that the customer would buy shares in another, usually “cold,” offering, or on paying excessive commissions to the underwriter. This proposal would also prohibit issuers, underwriters, broker-dealers, and other distribution participants from accepting an offer from a prospective purchaser to pay additional consideration in order to obtain an allocation of offered shares.

The Commission indicated that it believes that this prohibition is consistent with its long-standing position that tying the award of allocations to additional consideration is a fraudulent and manipulative practice, actionable under Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act. The Commission further stated that

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6 The Commission also proposes that Rule 17a-2(c) of the Exchange Act (which imposes certain record keeping and notification requirements) and Rule 481(d) (which requires certain information be included in a prospectus) and Item 508(l) of Regulations S-K and S-B (which imposes certain disclosure requirements for the “plan of distribution” section of a prospectus) be amended to eliminate all references pertaining to penalty bids.
Regulation M and the rules of self-regulatory organizations already prohibit some forms of tie-ins.

Nevertheless, the Commission believes that “a prophylactic rule specifically addressing the full range of misconduct that it observed in this context is necessary to preserve the integrity of the securities offering process and to protect investors.” The Commission views proposed new Rule 106 as a complement to the current provisions of Regulation M, which is necessary in light of what it describes as the “widespread nature of these abuses concerning underwriters inducing or accepting additional compensation from customers for allocations, as demonstrated by enforcement actions and studies. . . .”

The Proposing Release provides several examples of specific conduct the Commission intends to proscribe through proposed new Rule 106. For instance, the new Rule would prohibit distribution participants, issuers and their affiliated persons, in connection with allocating an offered security, from inducing, soliciting, requiring or otherwise accepting an offer from a potential purchaser to purchase any other security to be sold or proposed to be offered or sold by such person. Similarly, the new Rule would also prohibit distribution participants, issuers and their affiliated persons, in connection with allocating an offered security, from inducing, soliciting, requiring (or accepting an offer from) prospective customers to effect any other transaction or refrain from any of the foregoing, other than as stated in the registration statement or applicable offering document for the offer and sale of such offered security. The Commission notes that proposed new Rule 106 would apply to any distribution of securities, whether a public offering or private placement of securities, and would apply to initial as well as secondary offerings.

The Commission cautions that proposed new Rule 106 is not intended to interfere with legitimate customer relationships. For example, the provision is not intended to prohibit a firm from allocating IPO shares to a customer because the customer has separately retained the firm for other services, when the customer has not paid excessive compensation in relation to those services.

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This memorandum is for general information purposes only and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate developments, can be obtained from our website, www.simpsonthacher.com.