

MEMO# 18342

December 20, 2004

SEC PROPOSES AMENDMENTS TO REGULATION M

[18342] December 20, 2004 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 53-04 SEC RULES MEMBERS No. 177-04 RE: SEC PROPOSES AMENDMENTS TO REGULATION M The Securities and Exchange Commission has published for comment amendments to Regulation M under the Securities Exchange Act of 1934, which governs the activities of underwriters, issuers, selling security holders, and others in connection with offerings of securities.¹ The proposed amendments would prohibit certain activities that could undermine the integrity and fairness of the offering process, particularly with respect to the allocation of initial public offerings, and would enhance the transparency of underwriters' aftermarket activities. The most significant aspects of the proposed amendments are summarized below.

Definition of "Restricted Period" In order to address manipulative activities in connection with IPOs, the proposal would amend the definition of "restricted period" under Regulation M.² Specifically, the proposal would extend the restricted period for IPOs to 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. Currently, the restricted period definition references trading market information, i.e., average daily trading volume ("ADTV") and public float, and provides for either a one-day or a five-day restricted period based on these thresholds.³ For all other securities that do not satisfy the ADTV and public float levels, the restricted period is five days. Because there is no trading

¹ Securities Act Release Nos. 33-8511, 34-50831, and IC-26691 (Dec. 9, 2004), 69 Fed. Reg. 75774 (Dec. 17, 2004) ("Proposing Release"). Comments on the proposal are due to the SEC no later than February 15, 2005.

² As defined in Rule 100(b), "restricted period" is the time period during which 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.

³ The proposal would amend the definition of restricted period under Rule 100(b) to increase the ADTV and public float thresholds in order to adjust for inflation since Regulation M's adoption in 1996.

² market for IPOs, the restricted period for IPOs is five days. According to the Proposing Release, the Commission believes that such a restricted period is inadequate to address potentially manipulative conduct that can occur earlier than five days before an IPO's pricing and can adversely affect the pricing of the offering. The proposal would codify a long-standing Commission interpretation under Regulation M and its predecessor, Rule 10b-6, that the restricted period for mergers, acquisitions, and exchange offers includes "valuation" and "election" periods.

⁴ The

Proposing Release states that the Commission is codifying its position because corporate actions are price-sensitive times during which the incentive for interested persons to manipulate is high.

De Minimis Exception The current de minimis exception in Regulation M is intended to excuse from the Regulation's trading prohibitions small, inadvertent transactions that would not impact the market. Specifically, it excepts purchases and unaccepted bids during the restricted period that total less than two percent of the distributed security's ADTV only if the person making the bid or purchase maintains and enforces written policies and procedures reasonably designed to achieve compliance with Regulation M. In order to help prevent abuse of the de minimis exception, the Commission is proposing to modify Regulation M to require firms to create a separate record of each bid or purchase that is made in reliance on the de minimis exception.

Syndicate Covering Transactions and Penalty Bids The proposal would amend Regulation M to require any person communicating a bid that is for the purpose of effecting a "syndicate covering transaction" to identify or designate the bid as such whenever it is communicated.⁵ The Proposing Release states that the current lack of transparency of syndicate covering transactions has the potential to create a false or misleading appearance with respect to the trading market of the offered security. The disclosure requirement, therefore, would provide investors with information about the potential market impact of syndicate bidding and purchasing activity. The proposal would also prohibit the use of penalty bids.⁶ The Proposing Release notes that penalty bids are currently not prohibited under Regulation M but that the significant likelihood of harm through the use of penalty bids warrant its prohibition.⁷

4 Valuation periods refer to the time periods when the offered security's market price is a factor in determining the consideration paid in a corporate action. **Election periods** refer to time periods when shareholders have the right to elect among various forms of consideration. **5 Syndicate covering transactions** occur when the managing underwriter 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. **6 Penalty bids** are a means by which the managing underwriter may impose a financial penalty on syndicate members whose customers sell offering shares in the immediate aftermarket, i.e., "flipping." **7 The Commission requests comment** on a number of issues relating to syndicate covering transactions and penalty bids. Among other things, the Commission asks whether in addition to the proposed disclosure of information relating to syndicate covering transactions, it also should require a general notification to the market (e.g., through a press release) that syndicate covering activity has commenced or ceased. The Commission also requests comment on whether there are other aftermarket practices or policies that create conflict of interest that should be prohibited or subject to increased disclosure.

3 Prohibition on Certain Types of Consideration The proposal 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. The 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. According to the Proposing Release, the prohibitions would address certain abuses that occurred during the late 1990s in connection with "hot issue" IPOs, 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.⁸

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8 The Commission requests comment on several issues in connection with these prohibitions. Most significantly, the Commission requests comment on whether the proposal adequately protects legitimate customer relationships or might interfere with such relationships and should firms be required to create and maintain

records of indications of interest and the basis for IPO allocations.

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