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SEC, NYSE, and NASD Propose Rules for Allocation and Distribution of Offering Shares

On October 13, 2004, the Securities and Exchange Commission ("SEC" or the "Commission") approved publication of proposed amendments to Regulation M.[1] Adopted in 1996, Regulation M prohibits manipulative conduct by underwriters, issuers, selling security holders, and others with an interest in the outcome of an offering of securities.[2] Since then, and particularly during the "hot IPO" period of the late 1990s, the Commission has monitored the operation of the rules and determined that the actions of some distribution participants during securities offerings have been contrary to the underlying purposes of the rules, thereby meriting consideration of additional reform.

Specifically, the Commission proposes six amendments to Regulation M. The most significant element of the proposal is new Rule 106, which would expressly prohibit distribution participants, issuers, and their affiliated purchasers from demanding, soliciting, attempting to induce, or accepting from their customers any consideration in addition to the stated offering price of a security. This new rule is designed to prohibit arrangements between underwriters and potential purchasers conditioning allocation of shares on the purchaser providing additional business or excessive commissions to the firm in the aftermarket. Additionally, the SEC proposes to require syndicate covering bids to be publicly disclosed, lengthen the restricted period for IPOs, prohibit the use of penalty bids, require firms to keep records about use of the *de minimis* exception, and update dollar amount thresholds to adjust for inflation. Through the amendments, the Commission hopes to improve investor confidence in the integrity and fairness of the security offering process and thereby promote capital formation.[3]

The comment period for the proposed Regulation M amendments expires on February 15, 2005.

Recent rule proposals by the NYSE and NASD complement the SEC's attempt to provide the investing public with a greater degree of confidence in the IPO process and the capital markets as a whole.[4] Proposed NYSE Rule 470 and proposed NASD Rule 2712 would prohibit various abuses in the allocation and distribution of IPO shares. In particular, the proposed rules would prohibit *quid pro quo* arrangements whereby underwriters allocate IPO shares in exchange for excessive compensation from customers, "spinning" arrangements in which IPO shares are allocated in exchange for past or future investment banking business, and use of inequitable charges to customers in an attempt by broker-dealers to recoup penalty bids. Additionally, the new self-regulatory organization ("SRO") rules would address IPO pricing and the treatment of orders

1. Securities Act Release No. 8511, Securities Exchange Act Release No. 50831, Investment Company Act Release No. 26691 (Dec. 9, 2004), 69 Fed. Reg. 75774 (Dec. 17, 2004) ("Proposing Release"); see also Press Release No. 2004-145 (Oct. 13, 2004) ("SEC Proposes IPO Allocation Reforms").

2. See Securities Act Release No. 7375, Securities Exchange Act Release No. 38067, Investment Company Act Release No. 22412 (Dec. 20, 1996), 62 Fed. Reg. 520 (Jan. 3, 1997) ("1996 Adopting Release").

3. See Proposing Release at 75791.

4. See Securities Exchange Act Release No. 50896 (Dec. 20, 2004), 69 Fed. Reg. 77804 (Dec. 28, 2004) ("SRO Proposing Release").

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received for the purchase of IPO shares during the first day that the shares trade on the secondary market. Together with the proposed amendments to Regulation M, the proposed SRO rules would implement the vast majority of the recommendations of the IPO Advisory Committee, which was established at the request of the SEC in August of 2002 to consider reforms to the IPO underwriting process.[5]

Comments on the proposed new NYSE and NASD rules should be submitted to the SEC on or before January 18, 2005.

I. Proposed Amendments to Regulation M

A. Prohibition Against Tying Allocation of Shares to Aftermarket Activities

As noted, Regulation M is designed to protect the integrity of the offering process by prohibiting activities that could artificially influence the market for an offered security. However, in the Proposing Release the Commission notes that, during the late 1990's "hot issue" period, some syndicate members tied allocation of IPO shares to agreements that the customer purchase more shares in the aftermarket,[6] buy shares in a "cold" offering for another security, or pay unusually high commissions on transactions in unrelated securities. The Proposing Release states that such conditioning or tying may have added artificial support to stock prices by creating a perception of scarcity or aftermarket demand.[7] With proposed Rule 106, the SEC intends to eliminate these and similar artificial pricing influences.

Proposed Rule 106 would prohibit agreements between distribution participants and potential purchasers conditioning allocation of shares on aftermarket activities. Specifically, the rule would prohibit underwriters, issuers, and others participating in an offering from directly or indirectly demanding, soliciting, attempting to induce, or accepting "any consideration" in addition to that stated in the registration statement or applicable offering document.[8] Although noting that such practices are already actionable under Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act, the Proposing Release states that "[g]iven the widespread nature of these abuses . . . as demonstrated by enforcement actions and studies" the Commission believes an express prophylactic rule is desirable.[9]

Despite the apparent breadth of the rule, which prohibits "*any consideration*," the Commission has noted that the rule "is not intended to interfere with legitimate customer relationships. For example, this 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."[10] The Proposing Release requests comment on, among other things, whether the proposed language adequately protects legitimate customer relationships or might potentially interfere with ordinary firm behaviors such as rewarding good customers with allocations of IPO shares.[11]

B. Syndicate Covering Bids

Under Regulation M, underwriters engaging in transactions to cover a syndicate short position are required only to make a generalized disclosure in the offering prospectus that such activity may occur, and to notify the relevant SRO of such activity if and when it occurs. When the Commission adopted Regulation M, it recognized that at some point in the future further regulation of syndicate covering transactions might be required.[12] Recently, the SEC "staff has learned that in the US syndicate covering transactions have replaced (in terms of frequency of use) stabilization as a means to support post-offering market prices. Syndicate covering transactions may be preferred by managing underwriters primarily because they are not subject to the price and other conditions that apply to stabilization."[13] With the prevalence of such transactions, the Commission now believes that

5. See *NYSE/NASD IPO Advisory Committee, Report & Recommendations (May 2003)*, available at *http://www.nyse.com/pdfs/iporeport.pdf ("IPO Report"). The Committee's twenty recommendations related to four major subject areas: (1) The IPO process must promote transparency in pricing and avoid aftermarket distortions; (2) Abusive allocation practices must be eliminated; (3) Regulators must improve the flow of, and access to, information regarding IPOs; and (4) Regulators must encourage underwriters to maintain the highest possible standards, establish issuer education programs regarding the IPO process, and promote investor education about the advantages and risks of IPO investing.* See *IPO Report at 3.*

6. *The practice of conditioning IPO allocations on agreements by the purchaser to give orders to purchase shares in the aftermarket at particular prices is known as "laddering."*

7. *For example, the Commission and SROs recently have brought a number of actions alleging that underwriters used tying agreements to create false demand for shares and/or prop up aftermarket prices.* See, e.g., *Litigation Release No. 18385 (Oct. 1, 2003),* SEC v. J.P. Morgan Securities, Inc. *(settling charges of unlawful IPO allocation practices for $25 million).*

8. See *proposed Rule 106. The proposed rule applies to all distributions of securities, including both IPOs and secondary offerings.* See *Proposing Release at 75783 n.92.*

9. *Proposing Release at 75783-84.*

10. *Proposing Release at 75785.*

11. See *Proposing Release at 75785.*

12. See *1996 Adopting Release at 537-38.*

13. *Proposed Release at 75781. Under Regulation M, the underwriter of an offering is required to disclose stabilizing bids to both the relevant SRO and the person with whom the bid is entered. 17 C.F.R. 242.104(h)(1). In contrast, the underwriter may engage in transactions to cover short positions created in connection with the offering without making any contemporaneous public disclosure.*

greater transparency with respect to syndicate covering bids is necessary.

The SEC proposes to require that underwriters disclose syndicate covering bids as they occur. In particular, the Commission proposes to amend Rule 104(h)(2) 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."[14] Such covering bids would be identified to the SRO with direct authority over the principal market in the US for the security. The SEC has requested comment on whether disclosure of syndicate covering bids would have negative practical effects. Additionally, the Commission is interested in hearing whether disclosure of syndicate covering bids "wherever [they are] communicated" is sufficient, or whether supplemental notification to the market through a press release or website posting would be appropriate.

C. Restricted Period for IPOs

Regulation M imposes a restricted period in which distribution participants must refrain from activities that could stimulate the market for the offered security. Currently, Regulation M imposes a one-day restricted period for securities that have an average daily trading volume value of $100,000 or more and a public float value of $25 million or more.[15] All other securities not otherwise excepted by Regulation M have a restricted period of five-days.[16] The absence of a trading market for a security that is being offered for the first time, by definition, results in a five-day restricted period.

The Commission is concerned, however, that the absence of a trading market for IPOs means that there is no independent pricing mechanism by which a prospective investor can evaluate the IPO price set by underwriters and, as a result, fears that any inducement activity by underwriters or other distribution participants in an IPO can have long-lasting effects. Therefore, the proposed amendment to Rule 100(b) of Regulation M would establish a significantly longer restricted period specifically for first time offerings. Under the proposal, the IPO restricted period would extend from the earlier of the period beginning when the issuer reaches an understanding with an underwriter to proceed with a distribution or such time that a person becomes a distribution participant. The restricted period would conclude when the distribution is completed. Additionally, the proposal would refine the definition of restricted period for mergers, acquisitions, and exchange offers. The amended rule would explicitly state that the restricted period for mergers, acquisitions, and exchange offers includes valuation and election periods.

D. Penalty Bids

Regulation M currently permits managing underwriters to impose penalty bids on syndicate members whose purchasers "flip" the offered security in the immediate aftermarket. Under the Commission's proposal, Rule 104 would be amended to prohibit penalty bids. The primary motivations for this proposal appear to be concern that penalty bids operate as undisclosed forms of stabilization, improperly interfere with a customer's right to sell a security, and have been applied in a discriminatory manner by broker-dealers against retail as opposed to institutional customers. The proposed amendment to Rule 104 would state that "it shall be unlawful to impose or assess any penalty bid in connection with an offering."[17] The Commission considered a rule that would have allowed use of penalty bids so long as they were disclosed, but decided that such 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."[18]

E. The *De Minimis* Exception

Another proposed amendment to Regulation M would affect firms that avail themselves of the *de minimis* exception

14. See *proposed Rule 104(h)(2).*
15. *17 C.F.R. 242.100(b).*
16. *17 C.F.R. 242.100(b).*
17. See *proposed Rule 104(a).*
18. *Proposing Release at 75783.*

in Rule 101(b)(7), which excuses from Rule 101's trading prohibitions small, inadvertent transactions that total less than 2% of the distributed security's average daily trading volume. Under the proposal, such firms would be required to create a separate record of each bid or purchase that is made in reliance on the exception. By requiring firms to keep records about use of the *de minimis* exception, the Commission hopes to be able to identify firms who repeatedly rely on the exception, otherwise are abusing the exception, or whose compliance policies and procedures are inadequate to achieve compliance with Regulation M.

F. Dollar Amount Thresholds

The SEC also proposes to update the dollar amount thresholds used to determine a security's restricted period and the availability of the exception for actively-traded securities. The proposal would "simply reset the thresholds to the level of restrictiveness intended when Regulation M was adopted" by updating them to reflect the decrease in the value of money since 1996.[19] In particular, the average daily trading volume and public float value qualifying thresholds in Rules 100(b), 101(b)(7) and (c)(1), and 102(d)(1) would be increased by 20%.[20]

II. Proposed SRO Rules

A. *Quid Pro Quo* Arrangements

Proposed new NYSE Rule 470 and NASD Rule 2712 provide that no member, member organization, or person associated with a member or member organization may make allocation of IPO shares contingent on receipt of excessive compensation.[21] As with the SEC's proposed prohibition of agreements conditioning allocation of shares on aftermarket activities, these rules are not meant to interfere with legitimate customer relationships.[22]

B. Spinning Arrangements

The proposed SRO rules would prohibit underwriters from allocating IPO shares in exchange for past or future investment banking business — a practice commonly known as "spinning." Specifically, the proposed rules would prohibit members, member organizations, or persons associated with members or member organizations from allocating IPO shares to a company's executive officer or director when the company is a former or prospective investment banking client. Additionally, the rules would prohibit allocation of shares to a person materially supported by the company's executive officer or director.

The rules would ban spinning arrangements if: (1) the member has received investment banking compensation from the company within the last twelve months, (2) the member expects to receive or intends to seek investment banking business from the company within six months, or (3) there is an express or implied agreement that the company will direct investment banking business to the member in the future.[23] The rules also would create a rebuttable presumption that if a firm allocates IPO shares to an executive officer or director of a company and within six months receives investment banking business from that company, the IPO allocations were made with the expectation or intent to receive the investment banking business, and are thus prohibited.

C. Penalty Bids

The SRO rules, which were drafted based on current Rule 104, would prohibit members from imposing penalty bids unless the managing underwriter has assessed a penalty bid against the entire syndicate.[24] As noted above, the proposed amendments to Regulation M would prohibit penalty bids altogether.

D. IPO Pricing

Proposed NYSE Rule 470 and proposed NASD Rule 2712 are motivated by an intention to promote greater transparency in IPO pricing. To that end, the proposed rules would require that a member or member organization

19. *Proposing Release at 75778.*

20. *The consumer price index has increased by approximately 20% since 1996.*

21. See *Proposed NYSE Rule 470(A) and NASD Rule 2712(a);* see also *IPO Report at 12-13.*

22. See *SRO Proposing Release at 77807, 77810.*

23. See *Proposed NYSE Rule 470(B) and NASD Rule 2712(b).*

24. See *Proposed NYSE Rule 470(C)(1) and NASD Rule 2712(c)(1);* see also *IPO Report at 7.*

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acting as book-running lead manager of an IPO provide to the issuer, both before and after the distribution, information related to the interest by institutional and retail customers in the IPO and the allocation of IPO shares.[25]

Additionally, the proposed rules would require a book-running lead manager of an IPO to include provisions in a lock-up agreement that shares provided to the issuer's "friends and family" are subject to the agreement, and that the release or waiver of the agreement will be publicly announced.[26] Finally, under the proposed rules the book-running lead manager would need to establish an agreement with members of the syndicate that any shares returned by a purchaser to a syndicate member after secondary market trading commences would be used to cover any syndicate short position or would be offered at the public offering price to customers whose IPO orders were unfilled.[27] Placing these restrictions on returned shares would prevent the underwriter from allocating such shares to favored customers at the IPO price and thereby guaranteeing preferred customers an immediate locked-in profit.

E. Aftermarket Orders for IPO Shares

The IPO Report noted that IPOs are "inherently more volatile than stocks with a public trading history" and placement of market orders by individuals in the immediate aftermarket may "reflect neither their true investment decisions nor their reasonable expectations."[28] To protect individual investors and allow the market to develop more trading information, the SROs propose to prohibit members and member organizations from accepting market orders to purchase IPO shares during the first day that the shares commence trading on the secondary market.[29] Investors would continue to be permitted to place limit orders for IPO shares.

25. See *Proposed NYSE Rule 470(D)(1) and NASD Rule 2712(e)(1);* see also *IPO Report at 5, 16.*

26. See *Proposed NYSE Rule 470(D)(2) and NASD Rule 2712(e)(2);* see also *IPO Report at 13, 17.*

27. See *Proposed NYSE Rule 470(D)(3) and NASD Rule 2712(e)(3);* see also *IPO Report at 7-8.*

28. *IPO Report at 6.*

29. See *Proposed NYSE Rule 470(E) and NASD Rule 2712(e)(4);* see also *IPO Report at 6.*

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If adopted, the proposed amendments to Regulation M and proposed SRO rules would provide an additional element of regulation designed to increase investor confidence. If you would like copies of the Proposing Releases, or if you require further assistance, please contact:

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