Federal Register

Friday,
December 17, 2004

Part III

Securities and Exchange Commission

17 CFR Parts 228, 229 et al.

Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 228, 229, 230, 240 and 242

[Release Nos. 33–8511; 34–50831; IC–26691; File No. S7–41–04]

RIN 3235–AF54

Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (Commission) is proposing amendments to Regulation M under the Securities Exchange Act of 1934 (Exchange Act), which governs the activities of underwriters, issuers, selling security holders, and others in connection with offerings of securities. The proposed amendments are intended to prohibit certain activities by underwriters and other distribution participants that can undermine the integrity and fairness of the offering process, particularly with respect to allocations of offered securities. The proposal also seeks to enhance the transparency of syndicate covering bids, which may affect the aftermarket price and trading of an offered security, and prohibit the use of penalty bids. The amendments also are intended to update certain definitional and operational provisions in light of market developments since Regulation M's adoption. As a consequence of these proposed amendments to Regulation M, we are 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.

DATES: Comments should be received on or before February 15, 2005.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

• Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or

• Send an e-mail to *rule-comments@sec.gov*. Please include File Number S7–41–04 on the subject line; or

• Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

• Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File Number S7–41–04. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: James Brigagliano, Assistant Director, Joan Collopy, Special Counsel, Elizabeth Sandoe, Special Counsel, Liza Orr, Special Counsel, Elizabeth Marino, Attorney, or Denise Landers, Attorney Fellow, Office of Trading Practices and Processing, Division of Market Regulation, at (202) 942–0772, at the Securities Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed amendments to Regulation M [17 CFR 242.100, 242.101, 242.102, and 242.104], proposed rule 106 to the Regulation and Rule 17a–2 [17 CFR 240.17a–2] under the Exchange Act.

I. Introduction

Manipulation interferes with the securities markets' fundamental function as an independent pricing mechanism and undermines the markets' integrity and fairness. Under the securities laws, Congress granted the Commission broad authority to combat manipulative conduct. The Commission, in turn, has recognized that special opportunities and incentives for manipulation arise in securities offerings and has determined that certain offerings require specific regulation.[1] Consequently, the Commission has focused its regulation on market activities that could artificially facilitate an offering.

Because price integrity is essential during a securities offering, the Commission adopted rules to proscribe and regulate activities that offering participants could use to manipulate the price of the offered security. The anti-manipulation rules were first codified in 1955,[2] and today, Regulation M incorporates these provisions.[3] Regulation M, among other things, prohibits issuers, selling security holders, underwriters, broker-dealers, and other distribution participants[4] from directly or indirectly bidding for, purchasing, or attempting to induce any person to bid for or purchase any security that is the subject of the distribution during the applicable restricted period.[5] Regulation M proscribes activities that may increase a security's offering price, and so increase the offering proceeds; or may stabilize the market price of an offered security in order to avoid a price decline during the sales period or in the immediate aftermarket, or to induce or attempt to induce prospective investors to buy in the aftermarket.

Although the general antifraud and anti-manipulation provisions of the federal securities laws (*e.g.*, Section 17(a) of the Securities Act, and Sections 9(a), 10(b), and 15(c) of the Exchange Act[6] and Rule 10b–5 under the

[1] The primary focus of Regulation M, and its predecessor Rule 10b–6, is (1) offerings that raise manipulative concerns, defined as distributions; (2) persons who are likely to engage in manipulative activity; and (3) the activities that likely could raise or support the security's price. Securities Exchange Act Release No. 33924 (April 19, 1994), 59 FR 21681, 21684 (''Regulation M Concept Release'') (stating that a person contemplating or making a distribution has an obvious incentive to artificially influence the price of the securities in order to facilitate the distribution or increase its profitability and *citing Bruns, Nordeman & Co.,* 40 SEC 652, 660 n.11 (1961)); Securities Exchange Act Release No. 38067 (December 20, 1996), 62 FR 520 (January 3, 1997) (''Regulation M Adopting Release'').

[2] Securities Exchange Act Release No. 5194 (July 5, 1955), 20 FR 5075.

[3] Regulation M replaced former Rules 10b–6, 10b–6A, 10b–7, 10b–8, and 10b–21. *See* Regulation M Adopting Release, 62 FR at 520. Rules 101, 102, and 103 of Regulation M apply to distributions of securities, defined as an offering of securities, whether or not subject to registration under the Securities Act that are distinguished from ordinary trading by the magnitude of the offering and the presence of special selling efforts and selling methods. Rule 104 of Regulation M applies to offerings of securities, which generally encompasses all methods of offering and selling securities to investors. Regulation M Adopting Release, 62 FR at 535, n. 116. Rule 105 applies to offerings registered under the Securities Act, except offerings that are not firm commitment underwritings. 17 CFR 242.100 through 105.

[4] Under Regulation M, ''distribution participant'' is defined as an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution. 17 CFR 242.100(b).

[5] *See supra* note 3 for the definition of distribution. 17 CFR 242.100(b).

[6] 15 U.S.C. 77q(a); 15 U.S.C. 78i(a), 78j(b), and 78(o)(c).

Exchange Act[7]) apply to all securities transactions, Regulation M takes a prophylactic approach and is focused on particular activities in connection with securities offerings.[8] Rather than addressing manipulation after the fact, Regulation M seeks to prevent it by generally precluding certain persons from engaging in specified market activities. Also, unlike the more general anti-manipulation provisions, Regulation M does not require the Commission to prove in an enforcement action that distribution participants have a manipulative intent or purpose. As a prophylactic, anti-manipulation measure, Regulation M is designed to prohibit activities that could artificially influence the market for the offered security, including, for example, supporting the offering price by creating the exaggerated perception of scarcity of the offered security or creating the misleading appearance of active trading in the market for the security.

Regulation M consists of six rules. Rule 100 contains definitions of terms under Regulation M. Rule 101 governs the activities of underwriters and other persons participating in a distribution of securities and their affiliated purchasers.[9] Rule 102 governs the activities of the issuer, selling security holders and their affiliated purchasers. Rule 103 describes the conditions for permissible ''passive'' market making during the restricted period for a distribution of a Nasdaq security. Rule 104 governs stabilization, syndicate short covering activity, and penalty bids. Rule 105 prohibits covering short sales with offered securities purchased from an underwriter, broker, or dealer participating in an offering. Since Regulation M's adoption in 1996, the Commission has examined underwriting practices and aftermarket activities. In recent years, anti-manipulation regulation has been extensively and intensively scrutinized, with a particular focus on initial public offerings (''IPOs'').[10] Recent Commission[11] and SRO[12] actions and private litigation[13] have addressed certain misconduct in connection with IPOs.

On the basis of these developments, today we are proposing revisions to Regulation M and the addition of a new rule.[14] Our proposals would:

- Amend Rule 100's definition of ''restricted period'' with respect to IPOs and to expressly reflect the Commission's long-standing application of the definition in the context of mergers, acquisitions, and exchange offers;
- Amend Rule 101's ''*de minimis* exception'' to require recordkeeping;
- 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 Rule 104 to require disclosure of syndicate covering bids and to prohibit penalty bids;
- Amend Rule 104(j)(2) to include reference securities in the exception for transactions in securities eligible for resale under Rule 144A; and
- Adopt new Rule 106 to expressly prohibit conditioning the award of allocations of offered securities on the receipt of consideration in addition to the stated offering consideration.

As a consequence of these proposals, we are also recommending amendments to Rule 481 and Item 508 of Regulations S–K and S–B under the Securities Act concerning disclosure, and Rules 17a–2 and 17a–4 with respect to recordkeeping. We solicit specific comment on our approach and the specific proposals. We encourage commenters to present data on our proposals and any suggested alternative approaches.

II. Discussion of Proposed Amendments to Regulation M

A. Rule 100(b)

1. ''Restricted Period'' for IPOs

The Commission is proposing to amend the definition of ''restricted period'' in Rule 100(b) with respect to IPOs.[15] Specifically, the Commission is

---

[7] 17 CFR 240.10b–5.

[8] *See* Regulation M Concept Release, 59 FR at 21687 (noting purpose of the anti-manipulation rules is to limit the scope of market activity during securities offerings in order to prophylactically prevent manipulation).

[9] 17 CFR 242.101. An affiliated purchaser generally means a person acting, directly or indirectly, in concert with a distribution participant, issuer or selling security holder in connection with the acquisition or distribution of any covered security or an affiliate of a distribution participant, issuer or selling security holder, that directly or indirectly, controls the purchases of any covered security by a distribution participant, issuer, or selling security holder, whose purchases are controlled by or under common control with any such person. *See* 17 CFR 242.100(b).

[10] *See, e.g.*, NYSE/NASD IPO Advisory Committee, Report and Recommendations (*http://www.nyse.com/pdfs/iporeport.pdf*) (May 2003) (IPO Blue Ribbon Report); NASD Notice to Members 03–79 (December 2003) (adopting NASD Rule 2790 to prohibit sales of new issues to any account in which a restricted member has a beneficial interest); NASD Notice to Members 03–72 (November 2003) (proposing additional amendments to NASD Rule 2712 Governing Allocations and Distributions of Shares in IPOs (SR–NASD–2003–140)); NASD Notice to Members 97–34 (June 1997) (launching initial public offering tracking system by The Depository Trust Company to monitor flipping).

[11] *See, e.g.*, *SEC* v. *J.P. Morgan Securities, Inc.*, No. 03 Civ. 02028 (D.D.C. 2003), Complaint, (alleging violations of Regulation M); *SEC* v. *Robertson Stephens, Inc.*, Final Judgment of Permanent Injunction and Other Relief Against Robertson Stephens, Inc., 03 Civ. 0027 (RL) (D.D.C. 2003), Complaint ¶¶ 1, 5 (alleging violations of NASD Conduct Rules 2110 and 2330 and Section 17(a) of the Exchange Act and Rule 17a–3(a)(6) thereunder for improperly sharing customer profits by allocating ''hot'' IPO shares to customers and receiving in return shares of customer profits via excessive commissions or markdowns); *SEC* v. *Credit Suisse First Boston Corp.*, No. 1:02 CV 00090, 2002 WL 479836 (D.D.C. 2002), Complaint, ¶¶ 1, 6 (alleging violations of NASD Conduct Rules 2110 and 2330 and Section 17(a) under the Exchange Act and Rule 17a–3(a)(6) thereunder, for encouraging customers to channel profits from hot IPOs via excessive brokerage commissions); *In the Matter of Michael J. Markowski*, Securities Exchange Act Release No. 44086 (March 20, 2001) (finding a Rule 10b–6 violation when a broker-dealer firm instructed its brokers to solicit aftermarket orders during the distribution).

[12] *See* NASD Notice to Members 4–50 (July 2004) (announcing Bear Stearns & Co., Inc., Deutsche Bank Securities Inc., and Morgan Stanley & Co., Inc. were censured for engaging in improper IPO allocation practices and profit-sharing with customers by charging excessive commissions on listed agency trades within one day of allocating IPO shares to those customers). *See also supra* note 10, and accompanying text (detailing recent NASD actions to address the IPO allocation process).

[13] *See In re Initial Public Offering Securities Litigation*, 241 F. Supp. 2d 281 (S.D.N.Y. 2003) (denying defendant underwriters' motion to dismiss in case involving multiple allocating underwriters charged with market manipulation for requiring customers to engage in tie-in agreements and to pay undisclosed excessive compensation in order to receive allocations of IPO stock). *See also In re Initial Public Offering Antitrust Litigation*, 287 F. Supp. 2d 497 (S.D.N.Y. 2003) (finding that investors could not pursue antitrust claims against underwriters whom they alleged conspired to inflate aftermarket prices under doctrine of implied immunity); *Friedman* v. *Salomon Smith Barney, Inc.,* 313 F.3d 796, 801 (2nd Cir. 2002) (finding that underwriters and brokers are immune from antitrust liability for price stabilization practices in the aftermarket since it is the exclusive jurisdiction of the Securities and Exchange Commission).

[14] The Commission staff previously addressed manipulative conduct related to tie-in arrangements and solicitations for aftermarket purchases of an offered security in violation of Regulation M. *See* Division of Market Regulation: Staff Legal Bulletin No. 10 ''Prohibited Solicitations and 'Tie-in' Agreements for Aftermarket Purchases'' (August 25, 2000) (Staff Legal Bulletin 10). Although the aforementioned conduct would violate Regulation M or other provisions of the federal securities laws, or both, proposed Rule 106 would expressly prohibit the full array of fraudulent and manipulative conduct related to allocations of offered shares.

[15] 17 CFR 242.100(b) states that restricted period means: (1) For any security 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 one business day prior to the determination of the offering price or such time that a person becomes a distribution participant, and ending upon such person's completion of participation in the distribution; and (2) For all other securities, the

Continued

proposing new paragraph (4) to the definition to provide that the restricted period for an IPO would extend from 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.[16]

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.[17] The length of the restricted period is based on the liquidity of a security's trading market, specifically the value of the average daily trading volume (''ADTV'')[18] of the security and the value of the public float[19] of the issuer.[20] If a covered security has an ADTV value of $100,000 or more and a public float value of $25 million or more, then the restricted period begins on the later of one business day prior to the determination of the offering price, or such time that a person becomes a distribution participant (''one-day security'').[21] If a covered security's ADTV 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 such time that a person becomes a distribution participant (''five-day security'').[22] The restricted period generally ends, for all securities, upon such person's completion of participation in the distribution.[23] However, distribution participants and their affiliated purchasers are not subject to a restricted period for a covered security that has an ADTV value of at least $1 million and a public float value of at least $150 million (''actively-traded securities'').[24] 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 a public float value of at least $150 million.[25]

The restricted period provides a defined period of time during which the effects of a distribution participant's bids, purchases, or attempts to induce bids or purchases on the market price for a security may dissipate. It therefore allows other market participants to observe trading in the offered security unaffected by the activity of persons with an incentive to facilitate the distribution. With a one or five-day restricted period, investors and market participants should observe prices in the offered security that result from the natural forces of supply and demand.

A recent enforcement case alleged that a broker-dealer, prior to the pricing of IPOs, induced and attempted to induce investors to make aftermarket bids or purchases.[26] Inducements and attempts to induce aftermarket bids or purchases by distribution participants in order to facilitate a securities distribution interfere with the securities markets' function as an independent pricing mechanism and undermine the integrity of the capital raising process.[27] The activity often creates the exaggerated perception to investors of scarcity of IPO stock and can affect the pricing of the offering.

The restricted period definition references trading market information, *i.e.*, ADTV and public float, and provides two restricted periods based on these thresholds. Paragraph (2) of the definition provides that ''for all other securities'' that do not satisfy the ADTV and public float levels in paragraph (1) of the definition, the restricted period is five days. Currently, the absence of a trading market for IPOs has meant that the five-day restricted period applies to IPOs.

In the case of IPOs, however, the market influences underlying the one and five-day restricted periods do not apply. There is no trading market that would provide an independent pricing mechanism for prospective investors to evaluate the IPO price set by underwriters. Therefore, any inducement activity by underwriters and other distribution participants can have long-lasting effects.

Attempts to induce aftermarket bids or purchases that occur earlier than five days before IPO pricing can affect the pricing of an offering. Thus, the Commission believes that current Rule 100's application to IPOs that results in a restricted period that commences five

---

period beginning on the later of five business days prior to the determination of the offering price or such time that a person becomes a distribution participant, and ending upon such person's completion of participation in the distribution. (3) In the case of a distribution involving a merger, acquisition, or exchange offer, the period beginning on the day proxy solicitation or offering materials are first disseminated to security holders, and ending upon the completion of the distribution.

[16] A distribution is generally considered completed when the securities in the distribution have been distributed or acquired for investment, *e.g.*, when an underwriter's participation has been distributed and any stabilization arrangements and trading restrictions in connection with the distribution have been terminated. 17 CFR 242.100(b). Provided, however, that an underwriter's participation will not be deemed to have been completed if a syndicate overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of such exercise. *Id.* For a selling group member that is not part of the underwriting syndicate, its participation is completed when the selling group member has sold its entire allotment.

[17] 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. 17 CFR 242.100(b).

[18] ADTV is defined as the worldwide average daily trading volume during the two full calendar months immediately preceding, or any 60 consecutive calendar days ending within the 10 calendar days preceding, the filing of the registration statement; or, if there is no registration statement or if the distribution involves the sale of securities on a delayed basis pursuant to 230.415 of this chapter, two full calendar months immediately preceding, or any consecutive 60 calendar days ending within the 10 calendar days preceding, the determination of the offering price. 17 CFR 242.100(b).

[19] Rule100(b) provides that ''public float value shall be determined in the manner set forth on the front page of Form 10–K even if the issuer of such securities is not required to file Form 10–K * * *.'' 17 CFR 242.100(b).

[20] However, if the distribution involves a corporate action, current subparagraph (3) of the restricted period governs the commencement of the restricted period. This is the day that proxy solicitation or offering materials are mailed. Additionally, current paragraphs (1) and (2) of the restricted period definition would apply to any valuation or election period in connection with the corporate action.

[21] 17 CFR 242.100(b) definition of restricted period, subparagraph (1).

[22] 17 CFR 242.100(b) definition of restricted period, subparagraph (2).

[23] *See supra* note 15.

[24] 17 CFR 242.101(c)(1) (providing an exception for actively-traded covered securities if the distribution participant or its affiliated purchasers did not issue the security). We note, however, that there is no actively-traded securities exception for IPOs because they have no trading market.

[25] 17 CFR 242.102(d)(1) (providing an exception for actively-traded reference securities if the issuer or its affiliated purchasers did not issue the reference security). Rule 102 did not except all actively-traded reference securities, because the Commission determined that issuers and selling security holders have a high stake in the proceeds of an offering (and thus, an incentive to manipulate), and so, should not be able to trade in their securities, whether or not they are actively-traded. Regulation M Adopting Release, 62 FR at 531.

[26] *See SEC* v. *J.P. Morgan Securities, Inc., supra* note 11.

[27] Regulation M's proscription of attempts to induce bids and purchases are not intended to interfere with legitimate book-building. The determination as to whether an activity or communication constitutes legitimate book-building or an attempt to induce a bid or purchase in violation of Regulation M depends on the particular facts and circumstances surrounding such activity or communication.

days prior to pricing an IPO is inadequate to address potentially manipulative conduct because attempts to induce aftermarket bids and purchases are inappropriate at any time prior to the pricing and distribution of an IPO.

In order to combat manipulative abuses in connection with IPOs, the Commission is proposing new paragraph (4) to the definition of restricted period to specify that in the case of an IPO, the restricted period generally begins the earlier of: when the issuer reaches an understanding with the broker-dealer that is to act as its underwriter, or such time that a person becomes a distribution participant; or if there is no underwriter, when 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.[28] Additionally, the Commission is proposing to define IPO in Rule 100(b) to mean an issuer's first offering of a security to the public in the United States, and if prior to the offering the issuer's equity securities do not have a public float value, and the IPO would be an issuer's first offering of an equity security to the public in the United States. We propose to use this definition of IPO so that if an issuer's first offering of a security in the United States is debt, then both that debt offering and the issuer's first offering of an equity security in the United States would fall within this proposed definition of IPO. However, if an offered equity security already has a trading market either domestically or abroad for which ADTV and public float values may be calculated, then the equity offering would not be an IPO, and either a one or five-day restricted period would apply based on the ADTV and public float values. We also note that the actively-traded security or reference security exception would not apply to IPOs.

Q. Is there a different restricted period that should apply to IPOs that would more appropriately restrict potentially manipulative activity? Should the restricted period for IPOs begin earlier than proposed? Should the restricted period begin with the filing of the registration statement (or with the first circulation of an offering document to potential investors) for all IPOs, including IPOs that have an underwriter? Please provide specific reasons and information to support an alternative recommendation. Please provide empirical data, when possible, and cite to economic studies, if any, to support any alternative approaches.

2. Amendments to Rule 100(b)—''Restricted Period'' for Corporate Actions [29]

The Commission has a long-standing interpretation under both Regulation M and its predecessor, Rule 10b–6, that the restricted period for mergers, acquisitions, and exchange offers includes valuation and election periods.[30] Valuation periods refer to time periods when the offered security's market price is a factor in determining the consideration paid in a corporate action.[31] Election periods refer to time periods when shareholders have the right to elect among various forms of consideration.[32] These periods have been considered by the Commission to be included in the restricted period because they are deemed part of the distribution, and 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 rule text itself does not explicitly refer to valuation and election periods.[33]

Notwithstanding the long-standing interpretation, the staff occasionally receives inquiries about restricted periods concerning valuation and election periods in corporate actions. Therefore, we believe that expressly stating this interpretation in the rule would be beneficial. Accordingly, we propose to amend the definition of the restricted period in Rule 100(b) to include valuation and election periods and to add definitions for these terms.

Q. We seek specific comment concerning the proposal to incorporate the interpretation concerning election and valuation periods into the text of the restricted period definition.

B. Rule 100 Restricted Period Definition and Rules 101 and 102 Actively-Traded Security Exception: ADTV and Public Float Value Thresholds

As discussed earlier, Rules 101 and 102 of Regulation M prohibit certain persons from making bids or purchases during restricted periods, as defined in Rule 100(b). The applicable restricted period begins either one or five days before determining the offering price (or other applicable event) and is determined on the security's ADTV value and the issuer's public float value.[34] Securities that have an ADTV value of at least $100,000 of an issuer whose common equity securities have a public float value of at least $25 million have a restricted period that commences one day prior to the day of the pricing of the offering and for securities falling below those thresholds a five-day restricted period applies.[35] The Commission additionally determined to except actively-traded securities from the provisions of Rule 101, when such securities are not issued by the distribution participant or an affiliate thereof.[36] Similarly, actively-traded reference securities are excepted from the provisions of Rule 102 when such securities are not issued by the issuer, or any affiliate of the issuer, of the security in distribution.[37] Actively-

[28] An underwriter is defined as a person who has agreed with an issuer or selling security holder: (1) To purchase securities for distribution; or (2) to distribute securities for or on behalf of such issuer or selling security holder; or (3) to manage or supervise a distribution of securities for or on behalf of such issuer or selling security holder. 17 CFR 242.100(b).

[29] Restricted period means in the case of a distribution involving a merger, acquisition, or exchange offer, the period beginning on the day proxy solicitation or offering materials are first disseminated to security holders, and ending upon the completion of the distribution. 17 CFR 242.100(b).

[30] *See* Regulation M Adopting Release, 62 FR at 527 (stating that consistent with interpretations under Rule 10b–6, a restricted period under Regulation M would commence one or five days before the commencement of a valuation period, *i.e.*, a period where the market price of the offered security would be a factor for determining the consideration paid in a merger, acquisition or exchange offer, and continue for the duration of such period), *citing* Securities Exchange Act Release No. 19565 (March 14, 1983), 48 FR 10628, 10638 (stating that ''any period during which the market price of the offered security was a factor in determining the consideration to be paid pursuant to the merger ('valuation period') * * * the issuer was required to cease bidding for or purchasing the security five business days prior to and for the duration of the valuation period. A similar restriction was applied to any period during which the target company shareholders had the right to elect among various forms of consideration offered in connection with [a] merger ('election period').''). *See also* Division of Market Regulation Staff Legal Bulletin No. 9: Frequently Asked Questions About Regulation M (revised April 12, 2002) available at *http://www.sec.gov/interps/legal/mrslb9.htm* (stating ''the restricted period includes the valuation period as well. For instance, if the valuation period occurs outside of the proxy solicitation period, an additional restricted period would commence one or five business days prior to the commencement of the valuation period and continue until the valuation period ends.'').

[31] *See supra* note 30.

[32] *See supra* note 30.

[33] 17 CFR 242.100(b).

[34] *See supra* Section II.A. for a discussion of restricted periods and corresponding ADTV and public float value thresholds.

[35] 17 CFR 242.100(b).

[36] 17 CFR 242.101(c)(1). *Cf.,* Rule 100(b) definition of restricted period. 17 CFR 242.100(b). *See also supra* note 24.

[37] 17 CFR 242.102(d)(1). A reference security is a security into which a security that is the subject of

Continued

traded securities and reference securities are those with an ADTV value of at least $1 million and are issued by an issuer whose common equity securities have a public float value of at least $150 million.[38] In effect, these actively-traded securities and reference securities have no restricted period.[39] As discussed below, we now propose to increase the thresholds for the applicable restricted periods for the actively-traded securities and actively-traded reference securities exceptions in order to adjust for inflation since the time of Regulation M's adoption in 1996.

In excepting actively-traded securities from Rule 101 and actively-traded reference securities from Rule 102, the Commission believed that it was reasonable to rely on market mechanisms to curb the manipulative activity addressed by Regulation M.[40] In particular, the Commission reasoned that as the value of trading volume increased, it became less likely that a person could, cost-effectively, manipulate the price of the security.[41] Also, the Commission considered that actively-traded securities are followed widely by the investment community, and any aberrations in the price of an actively-traded stock would be observed by the investment community and corrected.[42] In addition, actively-traded securities are listed and traded on exchanges or other organized markets, and so are relatively transparent and subject to surveillance.[43]

The restricted period threshold levels were intended to apply only to those securities where the potential for manipulation was relatively limited and which would allow the effects of the market activities of distribution participants and issuers to dissipate.[44] Similarly, the Commission believed that the threshold values for the actively-traded security exception from Rule 101 and actively-traded reference security exception from Rule 102 would except securities as to which the potential for a successful manipulation is relatively limited.[45] The Commission is proposing to increase these threshold levels for the restricted period and actively-traded security and reference security exceptions to adjust for the effect of inflation. Since Regulation M was adopted in 1996, the value of the dollar has decreased due to inflation and has resulted in the ADTV and public float value thresholds becoming less restrictive than when Regulation M was initially adopted. As a result, more issuers' securities would now qualify for the restricted periods and for the actively-traded security exceptions and the lower thresholds may except from Regulation M's prohibitions securities that may be more susceptible to manipulation than we contemplated at adoption.[46] Part of this increase in the number of actively-traded securities and securities qualifying for a one- or five-day restricted period, is due to inflation's effect on the value of the dollar.

Because ADTV and public float value are measured in dollars, the general change in the value of the dollar since Regulation M's adoption has eroded the restrictiveness of the Regulation's threshold values. We believe that the level of restrictiveness we employed in 1996 for actively-traded securities remains an appropriate threshold, and therefore, in order to make the thresholds for the restricted period and actively-traded securities and reference securities current, the Commission is proposing to increase the ADTV and public float value thresholds to account for the decline in the value of the dollar that has occurred since 1996 (*i.e.*, adjust the values by the change in the Consumer Price Index (''CPI'')). Between 1996 and 2004, the CPI, a general measure for the change in the value of the dollar, rose approximately 20 percent.[47] The adjustment of the thresholds to reflect the current dollar value should simply reset the thresholds to the level of restrictiveness intended when Regulation M was adopted. As such, the adjusted thresholds should capture approximately the same type of issuers, with similar market liquidity and investment community following, as originally contemplated to be excepted when Regulation M was adopted.[48] Thus adjusting the thresholds would express in today's dollar value terms the same type of issuer meant to be excepted in 1996.

We propose to amend the Rule 100(b) definition of restricted period, the Rule 101(c)(1) exception for actively-traded securities, and the Rule 102(d)(1) exception for actively-traded reference securities to reflect an adjustment to the ADTV and public float values for the change in CPI. Specifically we propose to adjust the one-day restricted period to require at least $120,000 for ADTV value and $30 million for public float value, and to adjust the actively-traded security and reference security thresholds to require at least $1.2 million for ADTV value and $180 million for public float value, which reflects the change in the CPI Index from 1996 to 2004.

Q. Should the current thresholds for actively-traded securities, as well as the thresholds for one and five-day restricted periods, be adjusted by a factor other than CPI? If so, what factor should be used? Should the Commission consider adjusting these threshold values for this rise in the value of the market since Regulation M was adopted in 1996, for example, by the change in the S&P 500 or Dow Jones Industrial Average? Commenters should provide specific reasons and data in support of their statements and any

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. 17 CFR 242.100(b). See *also supra* note 25.

[38] 17 CFR 242.100(b). When Regulation M was adopted, the Commission believed the two-part ADTV and public float standard appropriately distinguished which securities were more difficult to manipulate. The Commission reasoned that the use of a trading volume standard alone would permit securities experiencing an unusual short-term volume increase in trading to be excepted from the restrictions of Rules 101 and 102. To avoid this result, the Commission added a public float component to the test, so that securities with an unusual increase in trading volume, but with a relatively small public float value, would be subject to the restricted periods under Rules 101 and 102. Regulation M Adopting Release, 62 FR at 527.

[39] It should be noted, however, that actively-traded securities and reference securities are not excepted from Rule 104 of Regulation M. 17 CFR 242.104.

[40] Regulation M Adopting Release, 62 FR at 527.

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] *See* discussion *supra* Section II.A.

[45] Regulation M Adopting Release, 62 FR at 527. The Commission observed that the exception would not compromise investor protection because the general antifraud and anti-manipulation provisions would continue to apply to offerings of actively-traded securities. Thus, distribution participants (and their affiliated purchasers) would continue to be prohibited from influencing the price of such securities to facilitate the distribution. Securities Exchange Act Release No. 37094 (April 11, 1996), 61 FR 17108, 17112 (April 18, 1996) (''Regulation M Proposing Release'').

[46] When we adopted Regulation M, the Commission estimated (based on 1995 data) a total of 4,255 securities would either have a one- or five-day restricted period, with 2,693 one-day securities and 1,562 five-day securities respectively. Additionally, 1,901 securities would qualify for the actively-traded security exception. Regulation M Adopting Release, 62 FR at 525, n. 37 (based on an analysis of NYSE, Amex and Nasdaq-listed securities). Today, based on 2003 data, approximately 4,667 securities would either have a one- or five-day restricted period, with 2,035 securities one-day securities and 2,632 securities five-day securities and 2,352 securities would qualify for the actively-traded security exception. These estimates are based on computations performed by the Office of Economic Analysis (''OEA''), July 8, 2004, using the CRSP database.

[47] The change in CPI is the percentage change in Urban CPI measured from July 1996 to July 2004, based on calculations performed by OEA.

[48] Adjusting the ADTV and public float value thresholds upwards for actively-traded securities by 20% would yield 2,353 issuers, or approximately 31% of all issuers would qualify as actively-traded securities. Based on calculations performed by OEA, in 1996 approximately 2,338 issuers were deemed actively-traded securities, which represented 27% of all issuers.

alternative measure for adjusting the ADTV and public float values suggested.

Q. Do ADTV and public float values provide an appropriate measure on which to base the actively-traded exception? That is, do these trading volume and public float criteria adequately identify a security's liquidity and depth? Are these criteria sufficient to identify securities that are more difficult to manipulate? Should other criteria in addition to, or in lieu of, ADTV and public float value be used? If so, please provide specific comment on other criteria and reasons to support your recommendation.

Q. Are the current actively-traded securities exception and one and five-day restricted periods under Regulation M set at appropriate threshold levels? That is, do the current ADTV value and public float value thresholds for actively-traded securities and for one and five-day restricted periods adequately balance the goal of maintaining market liquidity with the mandate to protect investors from manipulation? If not, what threshold levels would? Commenters should provide specific reasons and data in support of their statements and any alternative thresholds suggested.

C. Rule 101(b)(7)—De Minimis Exception

The *de minimis* exception in Rule 101(b)(7) is intended to excuse from Rule 101's trading prohibitions small, inadvertent transactions that would not impact the market.[49] It excepts purchases and unaccepted bids during the restricted period that total less than 2% 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. Moreover, a firm is expected to ''review its policies and procedures and modify them as appropriate'' in order to qualify for the exception.[50] Repeated reliance on this exception by distribution participants or their affiliated persons raises concerns about whether the transactions were ''inadvertent'' and the adequacy and effectiveness of a firm's compliance policies and procedures.[51]

From time to time, firms relying on this exception have informed the Commission's staff of an inadvertent bid or purchase that occurred during the restricted period. However, other firms similarly relying upon the exception may not inform the Commission's staff of that activity. Consequently, the Commission cannot know with a high degree of certainty how often the exception is used, whether certain firms repeatedly rely on it, or whether firms have adequate and effective procedures qualifying them for the exception.

Thus, 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, including among other things, that brokers and dealers specify the subject security, the day the restricted period commenced, the ADTV, and the bids or purchases that otherwise would violate Regulation M, including time, price, quantity, and market. Brokers and dealers would be required to maintain these records pursuant to proposed Exchange Act Rule 17a-4(b)(13). We believe this requirement would more easily allow Commission and SRO examiners to uncover patterns of abuse or policies and procedures that are not reasonably designed to achieve compliance with the rule.

Q. Is the proposed amendment an effective and efficient manner in which to guard against repeated reliance on the exception and promote effective compliance policies and procedures? Please provide any alternatives.

Q. Are there other aspects of the *de minimis* exception that the Commission should consider changing? For example, is the 2% ADTV threshold appropriate or should it be raised or lowered? Please provide data supporting your comment.

D. Rule 104—Syndicate Covering and Penalty Bids

We propose to amend Rule 104 of Regulation M to require any person communicating a bid that is for the purpose of effecting a syndicate covering transaction (''syndicate covering bids'') to identify or designate the bid as such wherever it is communicated and to prohibit the use of penalty bids.[52] ''Congress granted the Commission broad rulemaking authority to combat manipulative abuses in whatever form they might take.''[53] Congress also delegated to the Commission exclusive regulatory authority over price stabilization practices (*i.e.*, syndicate covering transactions and penalty bids) in Section 9(a)(6) of the Exchange Act.[54] ''In exercising its authority, the Commission [through Regulation M and its predecessor Rule 10b-6] has focused on the market activities of persons participating in a securities offering, and determined that securities offerings present special opportunities and incentives for manipulation that require specific regulatory attention.''[55] The objective of Regulation M is to preclude manipulative conduct by persons with an interest in the outcome of an offering and activity that undermines the integrity of the markets by interfering with the market's function as an independent pricing mechanism. Security offerings are particularly susceptible to manipulative abuse because persons, such as underwriters, who stand to profit from such offerings have special incentives to manipulate in order to facilitate the offerings.

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.[56] 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.[57] Syndicate covering transactions and penalty bids may have the effect of stabilizing the market price in connection with an offering, by preventing or retarding a decline in the market price of the offered security once aftermarket trading commences.[58]

[49] 17 CFR 242.101(b)(7).

[50] Regulation M Adopting Release, 62 FR at 530.

[51] Regulation M Adopting Release, 62 FR at 530 (stating that ''[t]he Commission notes that repeated reliance on the exception would raise questions about the adequacy and effectiveness of a firm's procedures'').

[52] 17 CFR 242.104. Rule 104 permits underwriters and syndicate members, in order to facilitate an offering, to conduct stabilizing and other aftermarket activities in compliance with the Rule's conditions. Unlike Rules 101 and 102, which apply only to distributions, Rule 104 is broader in that it applies to security offerings. *See* Regulation M Adopting Release, 62 FR at 535, n. 116 and supra note 3.

[53] *See* Regulation M Adopting Release, 62 FR at 520.

[54] *See Friedman* v. *Salomon Smith Barney, Inc.,* 2000 U.S. Dist. LEXIS 17785 (S.D.N.Y. 2000), aff'd 313 F.3d 796 (2d Cir. N.Y. 2002) (dismissing plaintiffs' claims on the basis that the defendants' use of penalty bids and other price stabilization practices used to combat flipping were subject to regulation by the Commission under Section 9(a)(6) of the Exchange Act and, therefore, immune from anti-trust attack).

[55] Regulation M Adopting Release, 62 FR at 520.

[56] A syndicate covering transaction is 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. 17 CFR 242.100(b).

[57] A penalty bid is 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. 17 CFR 242.100(b).

[58] ''Stabilizing'' means ''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). When adopting Regulation M, the Commission noted that ''syndicate short covering transactions and the

Continued

To enhance the transparency of syndicate covering transactions, we are proposing to amend paragraph (h)(2) of Rule 104 to require identification or designation of syndicate covering bids, analagous to the identification of stabilizing bids.[59] Specifically, the proposal would 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.[60] The proposal also would prohibit the use of penalty bids, as discussed below.

1. Overview of the Current Rule 104

Rule 104 governs stabilization,[61] syndicate covering transactions,[62] and penalty bids.[63] For stabilizing bids, the rule currently requires prior notification to the market on which such bids are effected and to the person with whom the bid is entered, but for syndicate covering transactions and penalty bids, only requires prior notification to the relevant SRO.[64] In the typical offering, the syndicate agreement allows the managing underwriter to ''oversell'' the offering, *i.e.*, establish a short position beyond the number of shares to which the underwriting commitment relates. The underwriting agreement with the issuer often provides for an ''overallotment option'' whereby the syndicate can purchase additional shares from the issuer or selling shareholders in order to cover its short position.[65] To the extent that the syndicate short position is in excess of the overallotment option, the syndicate is said to have taken an ''uncovered'' short position.[66] The syndicate short position, up to the amount of the overallotment option, may be covered by exercising the option or by purchasing shares in the market once secondary trading begins. Shares purchased in the market by or on behalf of the syndicate must be used to reduce the size of the syndicate short position. Therefore, the overallotment option may be exercised only to the extent required to cover the ''net'' short position.[67] Shares needed to cover the uncovered short position must be purchased in the market.[68]

Currently, issuers are required to inform investors that the syndicate may effect stabilizing and syndicate covering transactions, or impose penalty bids, in connection with the securities offering by providing a general description of possible stabilization, syndicate covering transactions and penalty bids in the Plan of Distribution or Underwriting section of the prospectus, if an underwriter intends to engage in any of these activities.[69] Generally, this disclosure is included in prospectuses for firm commitment offerings, regardless of whether the underwriters intend to or, in fact, stabilize the offering.[70]

2. Current Syndicate Practices

Underwriters assume a large measure of the risk that an offering may not be successful, and so have manipulative incentives to varying degrees throughout the offering process. The point in time when underwriters no longer have manipulative incentive or purpose to facilitate an offering cannot be identified with precision.[71] But the Commission has recognized that these incentives can continue into the aftermarket when syndicate covering transactions and penalty bids occur.[72]

The creation of a syndicate short position and the subsequent purchasing activity to cover the position can impact the offering and the aftermarket price. The potential ''buying power'' of the short position can allow the syndicate to price the offering more aggressively because its syndicate short covering can support the aftermarket at prices around or above the offering price, thereby validating the offering price. Purchasers in the offering also may conclude that the trading activity in the aftermarket validates the offering price, and therefore may be more inclined to retain the shares purchased in the offering

imposition of penalty bids by underwriters are activities that can facilitate an offering in a manner similar to stabilization.'' Regulation M Adopting Release, 62 FR at 537. Before Rules 10b-6 and 10b-7 were adopted, the Commission considered syndicate covering transactions to be a means of facilitating the distribution by supporting the market price of an offered security. Exchange Act Release No. 3506 (November 16, 1943), 11 FR 10965 (describing the conditions under which syndicate covering transactions may facilitate an offering). Stabilization, and syndicate covering transactions, are permitted only to prevent or retard a decline in the market price, and may not be used to raise the market price, or create a false or misleading appearance of either active trading in a security or with respect to the trading market for the offered security. *Id. See also* Proposed Rules: Stabilizing to Facilitate a Distribution, Securities Exchange Act Release No. 28732 (January 3, 1991), 56 FR 814.

[59] 17 CFR 242.104(h)(1). Consistent with the current disclosure requirement for stabilizing bids, the NASD requires market makers intending to initiate stabilizing bids to provide it with prior notice. *See* NASD Rule 4614. Stabilizing bids are then identified by a symbol on the Nasdaq quotation display. *Id.* In this way, the person engaged in stabilization satisfies the requirement to inform the market and the person to whom the bid is made of the stabilizing purpose of the bid by notifying the NASD. *See* Regulation M Adopting Release, 62 FR at 537. On the exchanges, underwriters must notify the exchange and provide disclosure to the recipient of the bid, *i.e.*, the specialist. *See* NYSE Rule 392; Regulation M Adopting Release, 62 FR at 537.

[60] Rule 104(h)(2) would continue to require prior notice to the self-regulatory organization with direct authority over the principal market in the United States for the security for which the syndicate covering transaction is effected. 17 CFR 242.104(h)(2).

[61] *See supra* note 58.

[62] *See supra* note 56.

[63] *See supra* note 57.

[64] 17 CFR 242.104(h)(1)–(2). For a discussion of Regulation M's notice requirement for stabilizing bids, *see* Regulation M Adopting Release, 62 FR at 537.

[65] ''Underwriters frequently receive an overallotment option (''Green Shoe''), which is the right, but not the obligation, to purchase securities from the issuer in addition to those initially underwritten by the syndicate, which may constitute up to 15% of the initial underwritten amount. Because the overallotment option may be insufficient to cover the entire syndicate short position, that portion in excess of the overallotment option must be covered through purchases in the secondary market.'' Regulation M Proposing Release, 61 FR at 17124, n. 86.

[66] The creation of an uncovered short position in connection with an offering is permissible activity that facilitates the offering, and is different from the delivery obligations related to ''uncovered short selling'' of securities in the secondary market that is discussed in the Regulation SHO Adopting Release. *See* Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004).

[67] If an underwriter were to exercise the Overallotment Option in an amount exceeding the net syndicate short position, under Regulation M and former Rule 10b–6, an underwriter's participation in the distribution would not be deemed completed and purchases made prior to the exercise of the option may violate Regulation M. *See* Regulation M Adopting Release, 62 FR at 522–23; Securities Exchange Act Release No. 19565 (March 4, 1983), 48 FR 10628, 10640. Underwriters and issuers also would have to consider any prospectus disclosure issues this may raise. *See infra* note 69.

[68] *See generally,* Loss, L and Seligman, J., *Securities Regulation,* 3d Section 2–A–2 (2004).

[69] Items 508(*l*) and 508(j) of Regulations S–K and S–B [17 CFR 229.508(*l*) and 228.508(j)]. Securities Act Rule 481(d) [17 CFR 230.481(d)] requires this disclosure in registration statements prepared on a form available solely to investment companies registered under the Investment Company Act of 1940 or in a Securities Act registration statement for a company that has elected to be regulated as a business development company under Sections 55 through 65 of the Investment Company Act [15 U.S.C. 80a–54—80a–64].

[70] The Division of Corporation Finance has issued interpretive guidance indicating that the Staff will issue comments if the disclosure regarding applicable short sale transaction does not address the following material points: (1) The potential for underwriter short sales in connection with the offering; (2) a description of short sales and uncovered short sales; (3) an explanation of when an uncovered short sale position will be created; (4) how underwriters close out covered short sales and uncovered short sale positions; (5) how underwriters determine the method for closing out covered short sale positions; and (6) the potential effects of underwriters' short sales and transactions to cover those short sales. *See* ''Current Issues and Rulemaking Projects,'' Nov. 14, 2000, Section VIII.A.3.c, at *http://www.sec.gov.* The guidance includes examples of language that issuers may use to provide the required disclosure.

[71] *See* Regulation M Proposing Release, 61 FR at 17124.

[72] *Id.* at 17124–17125.

rather than sell the shares to realize a gain or avoid a loss.

When we adopted Regulation M, we specifically recognized that underwriters frequently engage in syndicate covering transactions, and noted that these transactions can facilitate an offering in a manner similar to stabilization.[73] Currently, Rule 104 addresses the risk that stabilization will create a false or misleading appearance with respect to the trading market for the offered security by imposing pricing, disclosure, and other conditions on this activity.[74] Among other things, the Commission considered the contemporaneous disclosure that stabilization is occurring to be beneficial to market participants, because this information is important to their decisions to buy or sell the security.

Syndicate covering transactions are regulated quite differently under Rule 104, in large measure because the Commission had insufficient information about syndicate covering transactions when Regulation M was adopted.[75] We stated, however, that we could reconsider whether additional regulation was warranted.[76] Since that time, our staff has been reviewing syndicate covering transactions and other aftermarket practices. The staff has learned that in the U.S. syndicate covering transactions have replaced (in terms of frequency of use) stabilization as a means to support post-offering market prices.[77] 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 under Rule 104, and in particular the contemporaneous market disclosure of the bidding and purchasing activity.[78] However, the lack of transparency of syndicate covering transactions has the potential to create a false or misleading appearance with respect to the trading market for the offered security. Because syndicate covering transactions are not required to be disclosed to the market, investors (*i.e.*, those who purchased in the offering, as well as those who purchased in the aftermarket) are not informed about when the syndicate is actually making syndicate covering purchases in the market. As a result, investors have no way of knowing whether, and to what extent, the market price of the offered security may be supported by syndicate covering activity. Of note, once the managing underwriter has covered the syndicate's short position and ceases such purchasing in the aftermarket, there is often a significant decline in the security's price.[79] As a result, syndicate covering transactions can, and studies show that they do, enable underwriters to support the aftermarket price of the offered security at levels that they may not obtain in the absence of their activity, thereby interfering with free market forces.[80] Finally, the investing public who buy the offered shares in the aftermarket at syndicate-influenced prices unknowingly bear the risk of a significant subsequent decline in the security's price.[81]

3. Proposal for Syndicate Covering Transactions

As discussed above, stabilization and syndicate covering transactions can both be used to facilitate an offering by supporting the market price of the offered security, Rule 104 currently regulates these activities differently. While both stabilization and syndicate covering transactions support the price in the aftermarket of an offered security, they do operate differently. Stabilizing bids and purchases are conducted only by the managing underwriter who places bids at prices prescribed by Rule 104 to peg, fix, or stabilize the market price for the security. In contrast, the managing underwriter places syndicate short covering bids in the market, typically when the security is trading below the offering price, in order to deliver securities sold short in the offering, *i.e.*, cover the syndicate short position. This bidding and purchasing activity can also support the market price for the securities. Therefore, to address the disparate treatment of activities that similarly impact the aftermarket trading of an offered security, the Commission is proposing that Rule 104 be amended to require disclosure of syndicate covering bids. In particular, we propose to amend Rule 104(h)(2) 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.[82]

We believe that requiring syndicate covering bids to be identified or designated in this way would help protect investors by providing contemporaneous information about the potential market impact of syndicate

[73] *See* Regulation M Adopting Release, 62 FR at 537.

[74] Regulation M Adopting Release, 62 FR at 535. While Rules 101 and 102 primarily protect investors in the offering, the disclosure of the stabilizing bid's purpose under Rule 104 and the proposal regarding syndicate covering bids will benefit investors in the aftermarket of an offered security, as well as investors in the offering itself.

[75] *See* Regulation M Adopting Release, 62 FR at 537. Instead, the Commission required SRO notification and recordkeeping of syndicate covering transactions. In so doing, the Commission believed that SRO notification of syndicate covering transactions would serve to apprise regulators of their possible market effects, while the new recordkeeping requirements would assist the Commission in assessing whether further regulation was warranted. *Id.* at 537–538; Regulation M Proposing Release, 61 FR at 17125.

[76] Regulation M Proposing Release, 61 FR at 17125.

[77] *See, e.g.*, Ekkehart Boehmer and Raymond P.H. Fishe, ''Underwriter Short Covering in the IPO Aftermarket: A Clinical Study,'' 10 *Journal of Corporate Finance,* at 575–594 (September 2004) (finding that short covering trades are often used as a substitute for Rule 104 stabilization in that they serve the same purpose without the disclosure obligation associated with Rule 104 trades); Reena Aggarwal, ''Stabilization Activities by Underwriters After Initial Public Offerings,'' 55 *Journal of Finance* 1075, 1079 (June 2000) (finding that underwriters do not stabilize through stabilizing bids, but by overselling the issue and covering this short position by purchasing shares in the aftermarket).

[78] *Id.*

[79] *See, e.g.*, Reena Aggarwal, ''Stabilization Activities by Underwriters After Initial Public Offerings,'' 55 *Journal of Finance* 1075–1103 (June 2000) (noting that price levels decrease immediately after the underwriters' ''stabilizing'' activities cease); Kathleen Weiss Hanley, A. Arun Kumar, and Paul J. Seguin, ''Price Stabilization in the Market for New Issues,'' 34 *Journal of Financial Economics,* 177–197 (October 1993).

[80] *See, e.g.*, Ekkehart Boehmer and Raymond P.H. Fishe, *Who Ends up Short From Underwriter Short Covering? A Detailed Case Analysis of Underwriter Stabilization in a Large IPO,* at 32–34 (March 28, 2001) (finding that short covering trades can slow down price declines and that short covering reduces the price impact of a sell by more than 70%).

[81] *See, e.g., supra* note 79. Underwriters have an incentive to artificially influence aftermarket activity because they have underwritten the risk of the offering, and a poor aftermarket performance could result in reputational harm and subsequent financial loss.

[82] Rule 104(h)(2) would continue to require prior notice to the self-regulatory organization with direct authority over the principal market in the United States for the security for which the syndicate covering transaction is effected. 17 CFR 242.104(h)(2). Because Rule 104 already requires underwriters to make disclosures with respect to stabilizing bids, we believe it will not require significant effort or technical changes (to internal systems and procedures) on the part of underwriters or other syndicate members in order to comply with the proposed disclosure for syndicate covering bids. *See* text accompanying *supra* note 60. Moreover, while the burden would be on the underwriter or other person displaying or transmitting a syndicate covering bid to satisfy the proposed disclosure requirements, we anticipate that the SROs will make changes to their existing rules and procedures to assist their members in complying with these requirements. For example, a special symbol or identifier could be used to identify the bid as a syndicate covering bid. The Commission staff will coordinate with the SROs to develop procedures to provide wide notice of such bids to the markets. Moreover, we are soliciting comment from the industry as to whether the Commission should require broader dissemination of the fact that an underwriter is engaged in syndicate covering transactions (*e.g.*, by requiring the underwriter to publish a press release or issue some notice to the market), especially in cases where syndicate covering bids are not currently displayed to the market.

bidding and purchasing activity.[83] The proposal also would regulate consistently activities that are similar in terms of their market impact. While the Commission recognizes that stabilization and syndicate covering transactions both have the effect of supporting the market price of a security, these activities do operate differently, and so we are 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. Instead, the Commission will continue to monitor such transactions, and consider whether any additional regulation of syndicate covering transactions in the future is appropriate.

Q. Does the manner in which a managing underwriter effects syndicate short covering bids and purchases present issues for complying with the above notification and disclosure proposals? That is, would compliance with the proposal be complicated by the fact that managing underwriters may be purchasing for accounts other than the syndicate concurrently with making syndicate short covering bids and purchases? Please provide specific details of underwriter practices in this regard and suggest what modifications, if any, should be made to the proposal to address these concerns.

Q. What, if any, burdens would be imposed by the proposed disclosure? For example, would there be any difficulty in identifying or designating a bid as a syndicate covering bid (*i.e.*, by attaching a symbol or modifier to the bid) wherever it is communicated?

Q. Should the Commission consider, in addition to the proposed disclosure, revising Rule 104 to require a general notification to the market (*e.g.*, through a press release, a website posting, or an administrative message sent over the Tape) that syndicate covering activity has commenced (and another notification when syndicate covering activity has ceased)?

Q. Should the Commission consider revising Rule 104 to require disclosure, such as disclosure in a press release, of either or both of the following information: (1) That the underwriting syndicate has an uncovered short position in the offered security; and (2) the size of the syndicate uncovered short position. We seek specific comment concerning this alternative, or any other alternatives, the Commission should consider in regulating syndicate covering transactions. We also seek specific comment and empirical data regarding the current use of syndicate covering transactions and other aftermarket activities by underwriters in connection with securities offerings.

Q. Should the Commission require SROs to develop a mechanism for their members to comply with the Rule 104 proposal? Should the Commission consider using a different mechanism other than identifying or designating the bid itself, such as a press release or other notification mechanism? Should the SROs develop a mechanism on their own?

Q. Should the Commission impose specific price or other conditions on syndicate short covering bids or purchases in the aftermarket? If so, please provide specific comment on what conditions would be appropriate to apply and provide reasons for your recommendations.

Q. Should the Commission consider making the disclosure requirements for stabilization bids the same as the proposed requirements for syndicate covering bids? That is, should we also amend Rule 104(h)(1) to require that any person communicating a bid that is for the purpose of stabilizing identify or designate the bid as a stabilizing bid wherever it is communicated?

Q. Are there differences between stabilization and syndicate covering that would require different kinds of disclosure or other regulation for syndicate short covering? If so, please identify these differences and make recommendations about the way in which the proposed disclosure requirement should be modified?

4. Penalty Bids

Penalty bids are a contractual term in underwriting agreements that allow the lead underwriter to reclaim a selling concession paid to a syndicate member if that member's customers sell their allocated shares in the immediate aftermarket.[84] Penalty bid provisions are assessed at the election of the managing underwriter, and are not assessed in all offerings. We understand that penalty bids are rarely assessed, and are assessed 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.[85] Based on discussions between the staff and securities industry representatives, we also understand that syndicate managers justify the use of penalty bids by claiming that if the securities are sold within a short period of time, *i.e.*, flipped, the syndicate member has not earned its commission (*i.e.*, for selling shares to long-term investors) and the syndicate is entitled to reclaim the associated selling concessions via the penalty bid provision.

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, penalty 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, we understand that some sales representatives may fear losing a sales commission if their customers sell their IPO shares.[86] The salesperson's concern may result in improper interference with a customer's right to sell securities when the customer chooses to do so. Third, there is evidence that the assessment of penalty bids at the syndicate level results in discriminatory effects on the syndicate member's customers. In particular, we understand that institutional salespersons are not penalized when their institutional customers flip their shares, but retail salespersons often are penalized.[87] While internal compensation matters are not the focus of our proposed rule amendment, we are 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.[88]

Because we believe the likelihood of harm through the use of penalty bids is

[83] Regulation M Adopting Release, 62 FR at 537.

[84] 17 CFR 242.100(b). The immediate sale by an IPO purchaser is often referred to as "flipping." *See, e.g.*, Raymond P.H. Fishe, "How Stock Flippers Affect IPO Pricing and Stabilization," *Journal of Financial* and *Quantitative Analysis,* Vol. 37, No. 2 (June 2002).

[85] *See, e.g.*, Reena Aggarwal, "Allocation of IPOs and Flipping Activity," 68 *Journal of Financial Economics* 111–135 (April 2003) (finding that penalty bids are assessed in only 13% of offerings and amount to a small percentage of the total spread).

[86] *See, e.g.*, M. Siconolfi and P. McGeehan, "Flip Side: Wall Street Brokers Press Small Investors To Hold IPO Shares—Big Institutions Can Cash Out Quickly; the 'Little Guy' Can't Without Penalties—Rife With Double Standards?", *The Wall Street Journal,* at A.1 (June 26, 1998).

[87] *Id. See also* W. Wilhelm, Jr., "Secondary Market Price Stabilization in Initial Public Offerings," 12 *Journal of Applied Corporate Finance,* 78–85 (January 1999) (finding that the suppression of small-quantity orders by penalty bids, particularly during the first few days of trading, bears most heavily on retail investors receiving IPO allocations).

[88] We also are aware that, even where penalty bids are not imposed, some firms pressure their sales representatives to discourage customers from selling when a stock's price declines, unrelated to the recovery of any selling concessions. We understand that the NASD and the NYSE are currently in the process of rulemaking designed to address this specific concern. *See* File Nos. SR–NASD–2003–140 and SR–NYSE–2004–12 (publication pending).

significant, we propose that Rule 104 be amended to prohibit the use of such bids. In particular, we propose to add a new subparagraph under the Rule, which would state, ''it shall be unlawful to impose or assess any penalty bid in connection with an offering,'' and to eliminate the existing references to penalty bids in subparagraph (2) of the Rule. We also propose 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. While we considered requiring disclosure of penalty bids by sales representatives to customers, we do not believe that such disclosure would address the conflicts that arise with respect to their use. We also believe 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. We also understand that penalty bids are rarely assessed, so our proposal to eliminate their use should not have a great effect on the practices of most broker-dealers.

Q. Should the Commission consider, as an alternative, requiring syndicate members to disclose to their customers who seek to sell their IPO shares that the firm or sales representatives could have its selling concession reclaimed if the customer sells its IPO shares and that this raises a conflict of interest for the firm and its salespersons? Should we require disclosure of any other anti-flipping policies that the firm has in place that may affect an investor's decision to purchase or sell IPO shares? [89]

Q. Are there other aftermarket practices or policies that create conflicts of interest that should be prohibited or subject to increased disclosure? There may be other practices that investors should be made aware of, or other conduct that raises the same type of concerns as discussed above. For example, should the Commission prohibit firms from imposing anti-flipping policies that discriminate against retail investors, such as rescinding sales commissions for retail sales, or excluding retail customers (but not institutional customers) from future IPO allocations for quickly selling their IPO shares, or require disclosure of their policies? If so, please provide specific details regarding such practices or policies and suggest approaches to regulate such practices.

5. Rule 104—Exception for Transactions in Rule 144A Securities

Rule 104(j)(2) generally excepts from Rule 104 transactions in 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.[90] When we adopted Regulation M, the exception under Rule 104 was intended to be identical to the exception for Rule 144A securities under Rules 101 and 102.[91] We therefore propose to add the words ''or any reference security'' to Rule 104(j)(2) in order to make this subparagraph consistent with the same exception under Rules 101 (b)(10) and 102(b)(7) for transactions in Rule 144A securities.

Q. The Commission seeks specific comment concerning the proposal to add the omitted language ''or any reference security'' to Rule 104(j)(2).

E. New Rule 106

The Commission is proposing new Rule 106 of Regulation M 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.[92] 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,[93] or on paying excessive commissions to the underwriter.[94] 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.

1. Background

The Commission has long considered tying the award of allocations of offered shares to additional consideration to be fraudulent and manipulative, and such practices have always been actionable under Section 17(a) of the Securities Act and Section 10(b) and Rule 10b–5 of the Exchange Act.[95] In addition, some forms of tie-ins are already prohibited by Regulation M [96] and SRO rules.[97]

[89] For example, a firm may have a policy or practice of excluding clients from future IPOs if they flip shares, irrespective of whether a penalty bid is assessed.

[90] 17 CFR 242.104(j)(2). *See also* Regulation M Adopting Release, 62 FR at 536.

[91] Regulation M Adopting Release, 62 FR at 536, n. 119.

[92] This proposal would apply to any distribution of securities, *i.e.*, a public offering or private placement, and would apply equally to initial and secondary offerings.

[93] An IPO is considered to be a ''cold'' offering when there is weak investor interest in the IPO shares. An IPO is considered to be a ''hot'' offering when investor demand significantly exceeds the supply of securities in the offering. Shares in hot offerings often trade at substantial premiums to the offering price.

[94] The Commission has stated that such activity involves possible violations of the antifraud and anti-manipulation provisions of the federal securities laws. *See* Securities Exchange Act Release No. 9824 (October 16, 1972), 37 FR 22796 (October 25, 1972) (1972 Interpretive Release). *SEC* v. *Credit Suisse First Boston Corp.,* No. 1:02 CV 00090, 2002 WL 479836 (D.D.C. 2002), Complaint ¶¶ 1, 6 (alleging violations of NASD Conduct Rules 2110 and 2330 and Section 17(a) under the Exchange Act and Rule 17a–3(a)(6) thereunder, for encouraging customers to channel profits from hot IPOs via excessive brokerage commissions in order to receive such hot shares).

[95] *See supra* notes 6–7 and accompanying text. *See also C. James Padgett,* 52 SEC 1257 (1997), *aff'd sub. nom, Sullivan* v. *SEC,* 159 F.3d 637 (D.C. Cir. 1998) (finding underwriters violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b–5 thereunder by requiring that IPO purchasers sell their shares back to the firm at the beginning of aftermarket trading). *See also* 15 U.S.C. 77q (making unlawful fraudulent conduct in the offer or sale of any security or security-based swap agreement by means of interstate commerce); 15 U.S.C. 78(j)(b) and 17 CFR.240.10b–5 (making it unlawful for any person to ''employ any device, scheme, or artifice to defraud'' or to ''engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person''). A ''tie-in agreement'' in the securities offering context generally refers to requiring either implicitly or explicitly that customers give consideration in addition to the stated offering price of any security in order to obtain an allocation of the offered shares. Securities Exchange Act Release No. 10636 (February 11, 1974), 39 FR 7806 (February 28, 1974) (''1974 Rule 10b–20 Proposing Release''); Securities Exchange Act Release No. 11328 (April 2, 1975), 40 FR 16090 (April 9, 1975) (''1975 Rule 10b–20 Proposing Release''). These arrangements can also violate other provisions of the securities laws and SRO rules. *SEC* v. *Credit Suisse First Boston Corp.,* No. 1:02 CV 00090, 2002 WL 479836 (D.D.C. 2002).

[96] Securities Exchange Act Release No. 6536 (April 24, 1961) (reminding dealers that requiring customers to make purchases in the aftermarket for the offered security in exchange for allocations of that security violates the anti-manipulation rules including Rule 10b–6, the predecessor to Regulation M); Staff Legal Bulletin No. 10 (August 25, 2000), available at *http://www.sec.gov/interps/legal/slbmr10.htm.*

[97] *See* NASD Conduct Rule 2710 (2004) (requiring disclosure to the NASD of all relevant aspects of the offering including accurate disclosure of underwriting compensation); NASD Conduct Rule 2330 (2003) (prohibiting member firms from sharing

Continued

Underwriters' or issuer's demands for consideration in addition to the stated offering price have several pernicious effects. These activities can contribute to a false impression of scarcity in the offered shares. This, in turn, can stimulate and distort the offering and aftermarket prices by creating the impression that any unfulfilled demand for the offered shares may only be satisfied in the aftermarket.[98] Moreover, such activities create the impression that the underwriters have ''rigged the game'' and only the market participants who know they are expected, and are willing, to pay the additional consideration are able to participate in IPOs.

In 1974 and 1975, in order to broadly and explicitly address such manipulative conduct, the Commission proposed Rule 10b–20 to prohibit broker-dealers and others from (explicitly or implicitly) demanding from their customers any payment or consideration, including a requirement to purchase other securities, in addition to the security's disclosed offering price.[99] This proposal would have prohibited, for example, conditioning or ''tying'' an allocation of shares in a hot issue on an agreement to buy shares in another offering or in the aftermarket of another offering, for which there may be a lack of investor demand (*i.e.*, cold offerings).[100] When underwriters allocate shares in ''hot offerings'' to customers who agree to make aftermarket purchases in ''cold offerings,'' the purchasers in the cold offerings are deceived as to the true demand for that offering.[101] Proposed Rule 10b–20 also would have prohibited underwriters from requiring customers to pay excessive commissions or agreeing to profit sharing arrangements with distribution participants in order to receive allocations of IPO shares. The proposal also broadly prohibited any kind of arrangement where the customer would be required to perform any act, or refrain from any conduct, effect another transaction or refrain therefrom, other than what was disclosed in the registration statement or offering circular in order to receive an allocation.[102] The Commission withdrew the proposal in 1988, in part due to the passage of time since its proposal, and because the Commission believed that such agreements already could be reached under the existing antifraud and anti-manipulation provisions of the federal securities laws.[103]

During periods of high demand for new IPOs, such as occurred in the late 1990s, some underwriters induced or required customers who wished to receive ''hot'' IPO allocations to provide additional consideration to obtain an allocation of IPO shares. For example, the Commission has alleged that underwriters required or induced customers to pay excessive commissions[104] on transactions in other securities, to purchase ''cold'' IPO shares,[105] and to make purchases in the aftermarket[106] of the offered security.

Given the widespread nature of these abuses concerning underwriters inducing or accepting additional compensation from customers for allocations,[107] as demonstrated by enforcement actions and studies, we believe that an express Commission rule that complements the current provisions of Regulation M would be beneficial. Although this conduct may be actionable, for example, under current Regulation M, the general antifraud and anti-manipulation provisions of the federal securities laws, as well as SRO rules, we believe that a prophylactic rule specifically addressing the full range of misconduct that we observed in this context is necessary to preserve the integrity of the securities offering process and to protect investors.

profits with customer accounts); NASD Conduct Rule 2120 (2003) (prohibiting members from using manipulation, deception or fraud to induce or effect transactions in offered securities); NASD Conduct Rule 2310–2 (2002) (requiring fair dealing in all relationships with customers); 15 U.S.C. 78q(a) (requiring broker dealers to make and keep records of terms and conditions of all purchases and sales of securities); NASD Conduct Rule 2210 (2001) (establishing professional standard of conduct required of NASD members); NASD Conduct Rule 2110 (1996) (requiring that members observe ''high standards of commercial honor and just and equitable principles of trade''); 17 CFR 240.10b–5.

[98] *See* 1974 Rule 10b–20 Proposing Release, 39 FR at 7806 (describing how broker inducements for allocating offered shares: (1) encourages participation in cold offerings by investors with a view toward immediate resale of the security; (2) obscures actual demand for the offering making an assessment by investors of true demand difficult thus artificially affecting the offering price; and (3) stimulates demand for the offering and forces investors who could not participate to buy in the aftermarket).

[99] As proposed in 1975, Rule 10b–20 would have applied to offerings registered under the Securities Act or on Form 1–A. 1975 Rule 10b–20 Proposing Release, 40 FR 16090. As originally proposed in 1974, Rule 10b–20 would have applied to any securities offering utilizing jurisdictional means. 1974 Rule 10b–20 Proposing Release, 39 FR at 7806.

[100] *See* 1974 Rule 10b–20 Proposing Release (*citing* Securities Exchange Act Release No. 9824 (October 16, 1972), 37 FR 22796 (October 25, 1972) (''1972 Interpretive Release'') (noting that allocating customers shares of hot IPOs in exchange for customer purchases of cold IPOs violates the antifraud and anti-manipulation provisions of the Exchange Act).

[101] *See* 1974 Rule 10b–20 Proposing Release, 39 FR at 7806.

[102] 1975 Rule 10b–20 Proposing Release, 40 FR at 16091–16092.

[103] *See* Securities Exchange Act Release No. 26182 (October 14, 1988), 53 FR 41206. *See also C. James Padgett,* 52 SEC 1257 (1997), *aff'd sub. nom, Sullivan* v. *SEC,* 159 F.3d 637 (DC Cir. 1998) (finding underwriters violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b–5 thereunder by requiring that IPO purchasers sell their shares back to the firm at the beginning of aftermarket trading). Of note, the Commission determined that these tie-in agreements created a materially false impression of the extent of aftermarket activity. As such, the arrangement operated as a fraud upon the market and defrauded aftermarket purchasers. *Id.* at n. 53.

[104] *See SEC* v. *Credit Suisse First Boston Corp.,* No. 1:02 CV 00090, 2002 WL 479836 (D.D.C. 2002), Complaint ¶¶ 1, 6 (alleging violations of NASD Conduct Rules 2110 and 2330 and Section 17(a) under the Exchange Act and Rule 17a–3(a)(6) thereunder, for encouraging customers to channel profits from hot IPOs via excessive brokerage commissions). CSFB encouraged its retail customers to pay excessive commissions in correlation to the profit (sometimes up to 65%) they made in flipping their IPO shares through the purchases of off-setting trades in order to receive IPO allocations. *Id.* at ¶¶ 17–25, 42–43. *See also SEC* v. *Robertson Stephens, Inc.,* Final Judgment of Permanent Injunction and Other Relief Against Robertson Stephens, Inc., 03 Civ. 0027 (RL) (D.D.C. 2003), Complaint ¶¶ 1, 5 (alleging violations of NASD Conduct Rules 2110 and 2330 and Section 17(a) of the Exchange Act and Rule 17a–3(a)(6) thereunder for improperly sharing customer profits by allocating ''hot'' IPO shares to customers and receiving in return shares of customer profits via excessive commissions or markdowns). Robertson Stephens is alleged to have ranked customers according to customers' total commission dollars and used that ranking system to encourage customers to increase their commissions in order to receive IPO allocations. *Id.* at ¶¶ 14–26 . It was expected that a portion of the profits a customer made on an allocation would be filtered back to the firm by way of excessive commission business. *Id.* at ¶¶ 29–33. The NASD has also taken related actions involving payments of excessive commissions in exchange for IPO allocations. *See* NASD Notice to Members 4–50 (July 2004) (announcing that Bear Stearns & Co., Inc., Deutsche Bank Securities, Inc., and Morgan Stanley & Co., Inc. were censured for engaging in improper profit sharing with customers through the use of excessive commissions).

[105] *See SEC* v. *J.P. Morgan Securities, Inc.* at *supra* note 26 and accompanying text.

[106] *Id.*

[107] *See* Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88–95, pt. 1 at 555–56 (1 Sess. 1963) (noting that underwriters used manipulative tactics in order to increase issues to the level of ''hot'' offerings and create a ''pop'' in the offering price); Report of the Securities and Exchange Commission Concerning the Hot Issues Markets (August 1984) at 37–38 (noting existence of manipulative tie-in agreements during the hot issues market between 1980 and 1983); *SEC* v. *Credit Suisse First Boston Corp.,* No. 1:02 CV 00090, 2002 WL 479836 (D.D.C. 2002), Complaint ¶¶ 29–45 (noting that violative conduct was not isolated but rather business as usual and pervasive). Brokers expected customers to pay CSFB for having granted them ''hot'' IPO allocations, considering such allocations quick profits on which they (the underwriters) deserved something in return. *Id.* at ¶ 36. *See also SEC* v. *Robertson Stephens, Inc.,* Final Judgment of Permanent Injunction and Other Relief Against Robertson Stephens, Inc., 03 Civ. 0027 (RL) (D.D.C. 2003), Complaint ¶¶ 23–28 (pressuring customers to increase their commissions in order to receive allocations by use of their ''ranking system'').

2. Proposal

Proposed new Rule 106 of Regulation M would explicitly prohibit distribution participants, including underwriters, and issuers and their affiliates, directly or indirectly, from demanding, soliciting, or attempting to induce, or accepting an offer from their customers of any payment or other consideration in addition to the security's stated consideration. For example, this 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, Rule 106 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. 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.[108]

Rule 106 would complement the current provisions of Regulation M. Like Regulation M, the proposed rule is intended to protect the integrity of the offering process. Presently, the focus of Regulation M is on the protection of the integrity of the pricing of an offering by prohibiting distribution participants and issuers from bidding for, or purchasing, the offered securities in the market, or attempting to induce others to do so. Rule 106 would address a broad range of conduct by distribution participants and issuers that can stimulate the market for the offered shares (thereby distorting the offering price and the aftermarket). It also would address conduct that can operate as a fraud on prospective purchasers of IPOs, who are unaware of the underwriters' additional requirement for receiving an allocation.

We note, however, that the proposed 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. On balance, we believe a comprehensive rule specifically directed at the types of impermissible conduct discussed herein is warranted. Such conduct, which often recurs during ''hot issues'' periods, undermines the fundamental function of the securities markets as an independent pricing mechanism and erodes investor confidence in the securities offering process generally. Having a prophylactic rule that expressly addresses the conduct discussed above would therefore prevent potential misconduct in the future as well as enhance the Commission's enforcement capabilities.

Q. Is the language of the rule sufficient to address the full scope of manipulative conduct involved in the offering process, including the conduct discussed above? If it does not, how should the language be changed? What types of conduct should or should not be included within the rule? Please provide specific examples and any suggested alternative language.

Q. Commenters are asked to discuss whether the proposed language adequately protects legitimate customer relationships or might potentially interfere with these relationships. If the language does interfere with such relationships, please explain how and provide specific examples and recommendations.

Q. Although firms are required to create and maintain records of customer orders, should firms also be required to create and maintain records of indications of interest and the basis for IPO allocations? To what extent do firms already create and maintain records indicating that information? How burdensome would such a recordkeeping requirement be?

Q. Should the Commission consider prohibiting allocations of initial public offering shares to persons based solely on their status? For example, should a person be prohibited from receiving initial public offering shares because of his or her status as CEO of a public or nonpublic company?[109]

III. General Request for Comment

Any interested person wishing to submit written comments on any aspect of the proposed rules discussed in this release, as well as on other matters that may have an impact on the proposals contained herein, is requested to do so. Commenters should provide empirical data to support their views. The Commission also requests general comment on the following:

Rule 103 of Regulation M describes the conditions for permissible passive market making during the restricted period for a distribution of a Nasdaq security.[110] Passive market making was included in Regulation M to alleviate special liquidity problems that could exist for a Nasdaq security in distribution, if distribution participants or their affiliates who are Nasdaq market makers were required to withdraw from making a market during the restricted period.[111] The Commission is not proposing to amend Rule 103 at this time. However, as part our effort to comprehensively monitor the operation of Regulation M, we seek comment about Rule 103.

Q. Have the structural changes to the Nasdaq market since Regulation M's adoption affected the operation of Rule 103? Does Rule 103 continue to be necessary? If so, why? If not, why not?

Q. Does the existence of multiple sources of liquidity for Nasdaq securities, such as electronic communications networks (ECNs), alleviate the liquidity concerns Rule 103 was meant to address? If so, how? If not, why not?

IV. Paperwork Reduction Act

Certain provisions of the proposed amendments to Regulation M contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (PRA);[112] the Commission has submitted information to the Office of Management and Budget (OMB) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The Commission is revising the currently approved collection of information titled ''Regulation M'' under OMB control number 3235–0465. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

A. Summary of Collections of Information

1. Proposed Amendments to Rule 101(b)(7)[113]

The proposed amendments to Rule 101(b)(7) of Regulation M would require

[108] *See supra* note 3 for the definition of distribution. 17 CFR 242.100(b).

[109] *See* IPO Blue Ribbon Report, Recommendation 9.

[110] 17 CFR 242.103.

[111] *See* Regulation M Adopting Release, 62 FR at 534.

[112] 44 U.S.C. 3501 *et seq.*

[113] We have also proposed conforming changes to Rule 17a–4(b)(13) but the paperwork burden derives from the substance of the proposed amendments to Rule 101(b)(7) discussed herein.

distribution participants and their affiliated purchasers to maintain records of their reliance on the *de minimis* transactions exception from Rule 101 of Regulation M. Currently, Rule 101(b)(7) excepts from the rule's prohibitions purchases and unaccepted bids made by distribution participants and their affiliates during the restricted period that total less than 2% 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. When Regulation M was adopted, the Commission stated a firm is expected to ''review its policies and procedures and modify them as appropriate'' in order to qualify for the exception.[114] While broker-dealers are currently required under Rule 17a–3 under the Exchange Act to make and keep records of the terms of each brokerage order and each purchase and sale of a security for a period of three years, the proposed amendments to Rule 101(b)(7) would be a new collection of information because it would require firms to maintain a separate written record of information about each bid or purchase that is made in reliance on the *de minimis* exception. Like Rule 17a–3, the proposed amendment to Rule 101(b)(7) would require these records be maintained for a period of three years.

2. Proposed Amendments to Rule 104

The proposed amendments to Rule 104 of Regulation M would require any person communicating a bid for the purpose of effecting a syndicate covering transaction to identify or designate the syndicate covering bid as such wherever it is communicated. Rule 104 currently requires that any person effecting a syndicate covering transaction shall provide prior notice to the self-regulatory organization with direct authority over the principal market in the United States for the security for which the syndicate covering transaction is effected. We believe the identifying or designating the bid as a syndicate covering bid, would be an additional collection of information because the proposal would require entities to disclose syndicate covering bids.

B. Need for and Proposed Use of the Collection of Information

The information that would be required to be collected under the proposed amendments to Rules 101(b)(7) and 104 of Regulation M is necessary to prevent fraudulent, manipulative and deceptive acts by issuers, broker-dealers and others. The purpose of the proposed amendment to Rule 101(b)(7) is to have a record that would allow Commission and SRO examiners to review distribution participants' compliance with Rule 101 and to provide a basis for potentially uncovering patterns of abuse or policies and procedures that are not reasonably designed to achieve compliance with the regulation. The purpose of the proposed amendments to Rule 104 is to improve the transparency of syndicate covering bids through contemporaneous identification of the bid to the market where it is communicated in order to: (1) Protect the integrity of the trading market by providing investors, both in the offering and in the aftermarket, with contemporaneous information about actual syndicate purchasing activity, (2) preclude the manipulative effects of such bids, and (3) prevent the investing public from unknowingly bearing the cost of undisclosed syndicate covering activities.

C. Respondents

1. Proposed Amendments to Rule 101(b)(7)

The proposed amendments to Rules 101(b)(7) would require those distribution participants, and their affiliated purchasers who rely on the Rule 101 exception for *de minimis* transactions to make and keep records of the bids or purchases made in reliance on the *de minimis* exception. Therefore, the proposed amendments would apply to all distribution participants and their affiliated purchasers who rely on the exception in connection with follow-on, *i.e.*, secondary, distributions of securities other than those qualifying for the actively-traded securities exception under Rule 101 (*i.e.*, securities that have at least $1 million ADTV value and $150 million public float value). The Commission's Office of Economic Analysis (''OEA'') estimates that there are approximately 6,562 active broker-dealers registered with the Commission, of which 614 engage in underwriting.[115] Based on OEA's review of offerings in 2003, we estimate there are approximately 64 offerings annually of securities other than actively-traded securities.[116] Based on the staff's discussions with broker-dealers concerning their practices and experience with the *de minimis* transaction exception, we estimate that of the 614 brokers who engage in underwriting would utilize the *de minimis* transaction exception once every two years.

2. Proposed Amendments to Rule 104

Proposed amendments to Rule 104 will require distribution participants, such as managing underwriters, who are communicating a syndicate covering bid, to identify or designate the bid as a syndicate covering bid wherever it is communicated. Syndicate covering transactions typically are effected by a managing underwriter on behalf of the syndicate. Managing underwriters do not utilize syndicate covering transactions in all offerings. Rather, syndicate covering transactions generally occur in connection with IPOs. Further, only a fraction of all IPOs, typically those IPOs where supply exceeds investor demand for the offered security, are facilitated by the managing underwriter by means of syndicate covering transactions. The number of IPOs conducted per year is also dependent on general economic conditions, *e.g.*, the business cycle. As noted above, OEA estimates that approximately 614 active broker-dealers registered with the Commission engage in underwriting. The staff estimates that there were 88 equity IPOs in 2003, and that all such IPOs involved a managing underwriter.[117] Based on the staff's review of syndicate covering practices in a sample of offerings in one year, the staff believes that approximately 53% (or 47 offerings) of such IPOs were facilitated by syndicate covering transactions.

D. Total Annual Reporting and Recordkeeping Burden

1. Proposed Amendments to Rule 101(b)(7)

The proposed amendments to Rule 101(b)(7) of Regulation M would require all distribution participants and affiliated purchasers who rely on the *de minimis* exception to maintain a record of each bid or purchase made in reliance of the exception. We believe that distribution participants already make records of the type of information required in the proposed amendment to Rule 101(b)(7) since broker-dealers must record the terms of bids and transactions they effect under Rule 17a–3 and keep such records for 3 years. However, the proposal would require

[114] Securities Exchange Act Release No. 38067 (December 20, 1996), 62 FR 520, 530.

[115] This number is based on OEA's review of 2003 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

[116] This number is based on information provided by the SEC's Office of Economic Analysis.

[117] This number is based on information provided to the Commission staff by OEA.

that a record of the *de minimis* bids and purchases be kept separately. Thus, we believe the proposed amendments would impose an additional collection of information by requiring distribution participants to maintain the records separately.

Based on the staff's review of broker practices with respect to record keeping and their reliance on the *de minimis* transaction exception, we understand that the *de minimis* exception is rarely utilized by distribution participants and that it would take each broker approximately 20 minutes to create and maintain files for all *de minimis* bids and purchases made per offering. Based on the staff's review of broker-dealer experiences, we assume that one syndicate member per offering would rely on the *de minimis* exception once every 2 years (or 0.5 times per year). We estimate that the total estimated annual hour burden per year is 10.7 burden hours (the product of one syndicate member per offering, 64 offerings involving non-actively traded securities, 0.5 reliances per year, and 20 minutes recordkeeping per offering). We also estimate the paperwork compliance for the proposed amendments for each distribution participant per offering is approximately 10 minutes per year (the product of one syndicate member per offering, 0.5 reliances per year, and 20 minutes recordkeeping per offering). With respect to the proposed amendments to Rule 101(b)(7), we estimate that the broker-dealers bear 100% of the burden of preparation internally since the broker-dealers relayed to the staff that they would create and maintain such files internally.

2. Proposed Amendments to Rule 104

The proposed amendments to Rule 104 of Regulation M would require managing underwriters to identify or designate syndicate covering bids as such wherever communicated and to provide notice of its intention to engage in short covering to the SRO with direct authority over the principal market in the United States for the security for which the syndicate covering bid was made.

Managing underwriters do not utilize syndicate covering transactions in all offerings. Rather, syndicate covering transactions generally occur in connection with IPOs. Further, only a fraction of all IPOs, typically those IPOs where supply exceeds demand for the security, are facilitated by the managing underwriter by means of syndicate covering transactions. The number of IPOs conducted per year is also dependent on general economic conditions, *e.g.*, the business cycle. We estimate that approximately 614 active broker-dealers registered with the Commission engage in underwriting. In 2003, we estimate that there were 88 equity IPOs of which approximately 53% (or 47 offerings) involved a managing underwriting effecting syndicate covering transactions. We assume for purposes of this analysis that each offering had one managing underwriter. The staff reviewed the number of syndicate covering transactions made in a sample of offerings in a particular year and based upon that data, the staff believes that on average approximately 22 syndicate covering bids occur for each IPO that involves syndicate short covering.

It was determined at the time of Regulation M's adoption that in instances where such disclosure was required for stabilizing bids that it would require 15 minutes per bid.[118] We are requiring only identification of the syndicate covering bids in addition to that which is already required under Rule 104 and we believe this will impose only nominal costs and time upon the syndicate manager or other person communicating the syndicate covering bid.

Based on the number of IPOs in 2003 that involved syndicate short covering and the average number of short covering bids per offering, the annual number of syndicate short covering bids was 1034 (the product of 47 offerings, and 22 syndicate covering bids per offering). We estimate that identifying or designating each syndicate bid would take approximately 15 minutes. Thus, the total estimated annual hour burden per year is 258.5 burden hours (the product of 1034 syndicate covering bids and 15 minutes per bid). As stated above, typically the managing underwriter communicates the syndicate covering bid. Therefore, we also estimate that the paperwork compliance for the proposed rules for each managing underwriter is approximately 5.5 annual burden hours per offering (258.5 burden hours/47 offerings). With respect to the proposed Rule 104 amendments, we estimate that the syndicate member bears 100% of the burden of preparation internally because the managing underwriter communicates the syndicate covering bids on behalf of the syndicate.

[118] 62 FR at 542.

E. Collection of Information Is Mandatory

1. Proposed Amendments to Rule 101(b)(7)

The collection of information is mandatory if a distribution participant or its affiliated purchasers wish to rely on the *de minimis* transactions exception from Rule 101 of Regulation M.

2. Proposed Amendments to Rule 104

The collection of information is mandatory for all persons communicating a bid that is for the purpose of effecting a syndicate covering transaction.

F. Confidentiality

1. Proposed Amendments to Rule 101(b)(7)

The collection of information under the proposed amendments to Rule 101(b)(7) would be provided to Commission and SRO examiners, but not subject to public availability.

2. Proposed Amendments to Rule 104

The collection of information under the proposed amendments to Rule 104 would be communicated and displayed publicly.

G. Record Retention Period

1. Proposed Amendments to Rule 101(b)(7)

The proposed amendments to Rule 101(b)(7) would require a broker or dealer to preserve the records required under the rule in accordance with proposed Rule 17a–4(b)(13). Rule 17a–4(b)(13) would require distribution participants and their affiliated purchasers to create and maintain separate written records of each bid or purchase made in reliance on the *de minimis* exception for a period of three years, the first two years in an accessible place.

2. Proposed Amendments to Rule 104

The proposed amendments to Rule 104 do not contain any recordkeeping requirements.

H. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (1) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (2) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609, with reference to File No. S7–41–04. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–41–04, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 5th Street, NW., Washington, DC 20549. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

V. Consideration of Proposed Amendments to Regulation M's Costs and Benefits [119]

The Commission is considering the costs and benefits of the proposed amendments to Regulation M and new Rule 106 thereunder. The Commission is sensitive to these costs and benefits, and requests data to quantify the costs and the value of the benefits provided, and encourages commenters to discuss any additional costs or benefits beyond those discussed here. In particular, the Commission requests comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures, as well as any potential costs or benefits resulting from the proposals for registrants, issuers, investors, broker-dealers, other securities industry professionals, regulators and others. Commenters should provide analysis and data to support their views on the costs and benefits associated with the proposed amendments.

A. Proposed Amendments to Rule 100: Definition of Restricted Period and IPO

1. Benefits

We believe that the proposed amendments to Rule 100 of Regulation M would clarify what is considered to be an IPO under the regulation and when a restricted period under Rule 101 and 102 begins for IPOs, thereby facilitating compliance by distribution participants, issuers, their affiliates and others. By explicitly defining IPO we are helping to ensure that the extended restricted period will apply to an issuer's initial offerings of debt and equity, as well as clarifying when the extended restricted period would be applicable to issuers whose securities already trade on foreign markets. Similarly, we propose to amend the definition of restricted period to incorporate a long-standing interpretation under Regulation M, that is, to expressly describe the applicable restricted period for corporate actions such as valuation and election periods. We also propose to define these terms in Rule 100. By amending the definition of the restricted period to explicitly define the applicable restricted period for IPOs and for election and valuation periods, we would provide certainty to the issuers, distribution participants, their affiliates and others, as to when exactly the restricted period begins and ends. In addition, a defined restricted period for IPOs and explicitly defining the restricted period for valuation and election periods would help to combat manipulative abuses that may occur prior to an IPO and during price sensitive valuation and election periods and that have been the subject of recent enforcement actions. By prohibiting inducements, bids or purchases well in advance of IPO pricing the proposed amendment would allow the securities markets to function as independent pricing mechanisms by reflecting true demand for the security and improve the integrity of the capital raising process. Prohibiting such activity would also reduce the investors' perception of scarcity of IPO stock, which affects the pricing of and aftermarket trading in the IPO security.

2. Costs

The proposed amendment would expand the restricted period for an IPO so that such period would generally commence from earlier of (i) the time that an issuer reaches an understanding with the broker-dealer that the broker-dealer is to act as its underwriter or (ii) the time a registration statement is filed with the Commission or other offering document is first circulated to potential investors. This proposed expansion of the IPO restricted period, were it adopted, would capture in a prophylactic rule, conduct that is already actionable under the antifraud and anti-manipulation provisions of the federal securities laws. We note that the amendment applies only to IPOs which are a small portion of all offerings. Similarly, we propose to expressly describe the applicable restricted period for valuation and election periods. This proposal is an application of a long-standing, broadly published, interpretation regarding the application of Regulation M in the context of valuation and election periods.

We understand that distribution participants already have policies and procedures in place to monitor for compliance with the restricted periods under current Regulation M. The only incremental costs of the proposed restricted period for IPOs would be associated with monitoring for Regulation M compliance during that portion of the restricted period which is new—the period beginning when an issuer and broker dealer reach an understanding that the broker-dealer is to act an underwriter or when a registration statement is filed or offering document is circulated to potential investors until 5 days prior to pricing. Because there is no trading market for an IPO offered security prior to the pricing of offering, distribution participants should not incur any costs associated with monitoring for open market purchases during the new portion of the restricted period. However, there may be costs associated with training employees of distribution participants to understand the application of the proposed restricted period. However, as stated above, we believe such activity prior to an IPO is already prohibited by the general antifraud and anti-manipulation provisions of the securities laws and distribution participants and their employees should not engage in such conduct at any time prior to the distribution of the IPO. Similarly, distribution participants, issuers, their affiliates and others are already prohibited under Regulation M during election and valuation periods. As such, they should already have undertaken training, compliance procedures and monitoring to comply with the Regulation. Nonetheless, the proposals may require one-time changes by certain

[119] The Commission is also proposing certain conforming changes to Rules 17a–2, 17a–4, 104(j)(2) under the Exchange Act, and Rule 481 and Item 508 under the Securities Act. The costs and benefits, however, arise from the substance of the proposed amendments in the rule changes discussed herein.

distribution participants, issuers, affiliated purchasers and others. Thus, costs, if any, associated with training, modifying, revising policies and behavior and monitoring for compliance should be minimal.

Of note, we believe that costs, if any, associated with the proposed amendment concerning IPOs would only be borne by distribution participants. Our experience indicates that distribution participants, rather than issuers, have engaged in inducing or attempting to induce persons to bid for or purchase a covered security prior to the 5-day IPO restricted period. The Commission believes that even if there are some costs generated by this proposal, such costs are minimal and are justified by the facilitation of investment and enhancement of investor confidence in the IPO capital raising process that we believe will result from this proposal. We are however sensitive to potential costs borne by industry participants and generally solicit comment on any costs this proposed amendment could generate and whether the proposed amendments impose greater costs than presently exist under the federal securities laws.

B. Proposed Amendments to Rules 100, 101 and 102: ADTV and Public Float Value Thresholds

1. Benefits

The Commission believes the proposed adjustments to ADTV and public float values will reset the thresholds to their original restrictiveness and thereby appropriately apply the one- and five-day restricted period or actively-traded exception to the appropriate securities, thus minimizing the potential for manipulation during offerings. In order to make the thresholds for the restricted period and actively-traded securities and reference securities current, the Commission is proposing to increase the ADTV and public float value thresholds to account for the decline in the value of the dollar that has occurred since 1996 (*i.e.*, adjust the values by the Consumer Price Index (''CPI''). Between 1996 and 2004, the CPI, a general measure for the change in the value of the dollar rose approximately 20 percent.[120] The adjustment of the thresholds to reflect the current dollar value should simply reset the thresholds to the level of restrictiveness intended when Regulation M was adopted. By resetting the ADTV and public float thresholds, the proposal would apply the actively-traded security exception and one- or five-day restricted period to the type of issuers and securities the Commission had considered appropriate at Regulation M's adoption, *i.e.*, those with a relatively limited potential for manipulation.

2. Costs

The Commission believes that the adjustment to ADTV and public float value would not impose costs in addition to those considered when Regulation M was adopted since the amendments will reinstate the level of restrictiveness in effect at the time of Regulation M's adoption. As a practical matter, should the ADTV and public float values be adjusted as proposed, certain issuers or securities will no longer be exempt from Rules 101 and 102 or will be subject to a longer restricted period, and so issuers, distribution participants, their affiliates and others must modify their activities to comply with the applicable restricted period. This adjustment to a different restricted period (either one- or five-day, or none) may impose some initial costs upon issuers, distribution participants, their affiliates and others. The one- and five-day restricted periods, however, have been in place since 1997 so issuers, distribution participants, their affiliates and others should already have the capabilities and policies and procedures in place in order to be able to impose such restrictions on issuers and their securities. At this time, the Commission believes this one-time modification by issuers, distribution participants and their affiliates, should be minimal. The Commission has no data on these costs and solicits comments as to whether the proposed amendments impose greater costs on issuers than the current rule.

C. Proposed Amendments to Rule 101(b)(7): De Minimis Exception

1. Benefits

We believe the proposed amendments to Rule 101(b)(7) of Regulation M would enhance compliance with Regulation M and assist the Commission and SRO examiners in identifying patterns of abuse or policies and procedures that are not reasonably designed to achieve compliance with the rule.

2. Costs

As discussed in the PRA, the proposed amendments to Rules 101(b)(7) would involve a collection of information since those distribution participants, and their affiliated purchasers who rely on the Rule 101 exception for *de minimis* transacations would be required to make and keep records of the bids or purchases made in reliance on the *de minimis* exception. As discussed below, the staff estimates this annual burden to be 10.7 burden hours.

Currently under Regulation M, distribution participants, their affiliates and others are expected to ''review [their] policies and procedures and modify them as appropriate'' in order to qualify for the *de minimis* exception and no additional requirement concerning policies and procedures is proposed at this time. Additionally, broker-dealers are already required under Rule 17a–3 of the Exchange Act to make and keep records of the terms of each brokerage order and each purchase and sale of a security for a period of three years. The proposed amendments would only require firms to maintain a separate written record of the terms of the bids and purchases made in reliance upon the exception from Rule 101 for a period of 3 years. Based on discussions with distribution participants about their experience with the *de minimis* exception, the Commission believes these would be infrequent violations requiring infrequent recordkeeping. Further, the review of the policies and procedures is already required under Regulation M. For purposes of the PRA, the staff estimates an annual burden of 10 minutes per distribution participant to keep separate records of their reliance on the exception. Therefore, the staff believes the proposed amendments regarding recordkeeping of *de minimis* violations of Regulation M would impose minimal costs.

D. Proposed Amendments to Rule 104: Syndicate Covering and Penalty Bids

1. Benefits

Identification or designation of syndicate covering transactions would help to protect investors by providing contemporaneous information about the actual occurrences of syndicate purchasing activity. The proposal obligates managing underwriters and others communicating a syndicate covering bid to identify it as such wherever the bid is communicated. The staff believes such identification is an essential first step to market-wide identification of syndicate covering bids. Contemporaneous disclosure of the fact that stabilization-like activity is occurring is beneficial to the market and its participants, because it would allow market participants, *i.e.*, both holders of offered shares and potential investors in the secondary market, to base their

[120] The change in CPI is the percentage change in Urban CPI measured from July 1996 to July 2004, based on calculations performed by OEA.

investment decisions and the resulting transactions on all available information. This proposed amendment also would inhibit underwriters from pricing offerings at higher levels than otherwise may be obtainable in the absence of their syndicate covering activity in the subsequent trading market.

The proposal to prohibit penalty bids would greatly reduce the pressure of a penalty bid assessment by a managing underwriter on a syndicate that, in turn may result in discriminatory and improper conduct by the syndicate member and its salespeople toward its customers who may wish to sell a security purchased in an offering.

2. Costs

Proposed amendments to Rule 104 would require managing underwriters to identify or designate syndicate covering bids as such wherever communicated. For purposes of the PRA we estimated an annual burden of 5.5 hours per year for managing underwriters to comply. The Commission recognizes that SROs and markets receiving designation of a syndicate bid from managing underwriters could incur some costs to communicate this information to the market. The required disclosure and designation of a syndicate bid, however, is similar to what is already required for stabilizing transactions, so the Commission anticipates that the means of communicating such information is already in place and operational. Issuers may also incur one-time costs related to modifying the disclosure language in the Plan of Distribution.

Although penalty bids are infrequently used, due to their elimination managing underwriters and issuers will no longer have the option of using them and may impose minimal costs upon them. Overall, the staff believes the costs of complying with the Rule 104 proposals would be minimal and the benefits from improved transparency and removal of penalty bids would outweigh these costs.

E. Rule 104—Exception for Transactions in Rule 144A Securities

1. Benefits

We believe that the proposed amendment to Rule 104(j)(2) to include ''reference securities'' will make the subparagraph consistent with the same exception under Rules 101(b)(10) and 102(b)(7) for transactions in Rule 144A securities, as was intended when Regulation M was adopted and will clarify the application of the exception.

2. Costs

The Commission preliminarily believes that including reference securities in the 144A exception of Rule 104 would impose minimal costs since it clarifies what securities are excepted and may require a one-time adjustment by training and modifying procedures by distribution participants and others.

F. Proposed Rule 106: Unlawful Practices in Connection With Allocations of Offered Securities

1. Benefits

We believe that proposed Rule 106 would help prevent abuses in awarding allocations of offered securities, particularly IPOs, that were common in the late 1990's and other ''hot issue'' periods. Underwriters'' or issuer's solicitations, inducements, demands for, or acceptance of, consideration in addition to the stated offering price have several pernicious effects. These activities by distribution participants can contribute to a false impression of scarcity in the offered shares. This, in turn, can stimulate and distort the offering and aftermarket price of the offered security by creating the impression among investors that any unfulfilled demand for the offered shares may only be satisfied in the aftermarket.[121] Moreover, such activities create the impression that the underwriters have ''rigged the game'' and only the market participants who know they are expected, and are willing, to pay the additional consideration are able to participate in IPOs. Additionally, when underwriters allocate shares in ''hot offerings'' to customers who agree to make aftermarket purchases in ''cold offerings,'' the purchasers in the cold offerings are deceived as to the true demand for that offering. The proposed rule would expressly preclude conduct that can operate as a fraud on prospective and actual purchasers of an offered security, particularly in IPOs. Such conduct can undermine the fundamental function of the securities markets as an independent pricing mechanism and erode investor confidence in the securities offering process generally. Having an express prophylactic rule that prohibits the conduct would emphasize to distribution participants that engaging in such activity is prohibited and would assist the Commission in its enforcement of the federal securities laws.

2. Costs

The Commission notes that the conduct the proposed rule prohibits is already prohibited by Regulation M or is illegal under the antifraud and anti-manipulation provisions of the federal securities laws, as well as under SRO rules, and so the new Rule 106 does not add any additional requirements. Rather, it expressly prohibits such conduct. A few distribution participants, their affiliates and others who did not already have adequate policies and procedures may need to make a one-time revision and undertake corresponding training of employees. The Commission therefore believes that the proposed rule would impose minimal costs, if any, on distribution participants, issuers and their affiliated purchasers and would support investor protection.

VI. Consideration on Burden and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and must consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.[122] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.[123] Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission preliminarily believes that the proposed amendments to Regulation M are intended to improve market efficiency by providing greater clarity to all issuers, distribution participants and their affiliated purchasers as to the scope of permissible activity for offerings; helping to ensure that those securities excepted from the rules have no potential for manipulation; requiring companies to maintain records of inadvertent violations of Regulation M and to revise policies and procedures in order to prevent violating rules; and

[121] *See* 1974 Rule 10b–20 Proposing Release (describing how broker inducements for allocating offered shares: (1) Encourages participation in cold offerings by investors with a view toward immediate resale of the security; (2) obscures actual demand for the offering making an assessment by investors of true demand difficult thus artificially affecting the offering price; and (3) stimulates demand for the offering and forces investors who could not participate to buy in the aftermarket). 1974 Rule 10b–20 Proposing Release, 39 FR at 7806.

[122] 15 U.S.C. 78c(f).

[123] 15 U.S.C 78w(a)(2).

providing greater transparency to the market of actual syndicate covering transactions. The proposed amendments are intended to promote transparency and prevent manipulative activity in the offering process and aftermarket.

The Commission preliminarily believes that the proposed amendments would promote capital formation since they seek to eliminate the abuses in the offering process and would promote a more even playing field for potential investors and issuers alike. These proposed amendments would promote investor confidence in the offering process as well as in the market as a whole, which would foster capital formation.

The Commission has considered the proposed amendments in light of the standards cited in Section 23(a)(2) and believes preliminarily that, if adopted, they would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act. Specifically, the proposed amendments if adopted, would require maintenance of separate records under Rule 101(b)(7) and identification or designation of syndicate covering bids under Rule 104. As discussed above, distribution participants under Rule 17a–3 already make and keep records of all orders and purchases and sales, including *de minimis* bids and purchases, so the Commission believes the additional burden of keeping records separately and for three years would be minimal. With regard to Rule 104, the Commission recognizes that SROs and markets receiving the identification or designation of a syndicate bid from managing underwriters may incur some costs to communicate this information. The required designation of a syndicate bid, would be analogous to what is already required for stabilizing transactions, so the Commission anticipates that the means of communicating such information is already in place and operational and would require minimal costs to extend such designation to include syndicate covering bids. Additionally, in regard to the proposed definition of IPO and expansion of the restricted period for IPOs we would be expressly prohibiting conduct which can create an exaggerated perception to investors of scarcity of IPO stock and affect the pricing of the offering, both of which undermine the market's function as an independent pricing mechanism. The proposed amendments to Rules 100, 101, and 102 concerning ADTV and public float values will restore the restricted period and actively-traded thresholds to the level originally contemplated at Regulation M's adoption. By expressly providing for valuation and election periods within the definition of the restricted period the Commission would codify a long-standing interpretation and eliminate any confusion in these contexts. The new Rule 106 would expressly prohibit in a prophylactic rule conduct related to offerings that has been the subject of recent enforcement actions. Since the conduct covered by proposed Rule 106 is already prohibited under either Regulation M or antifraud and anti-manipulation provisions of the federal securities laws, the staff codifying the illegality of such conduct within a prophylactic rule imposes minimal additional costs and would not impose a burden on competition.

We preliminarily believe that the proposed amendments would promote competition among distribution participants as the amendments would level the playing field by applying clear and uniform regulation concerning conduct during an offering, and by improving the transparency of syndicate covering bids in the aftermarket.

The Commission requests comment on whether the proposed amendments are expected to promote efficiency, competition, and capital formation.

VII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or (SBREFA),[124] we must advise the Office of Management and Budget as to whether the proposed amendments constitute a ''major'' rule. Under SBREFA, a rule is considered ''major'' where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment, or innovation.

If a rule is ''major,'' its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

VIII. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (IRFA), in accordance with the provisions of the Regulatory Flexibility Act (RFA)[125] regarding the proposed amendments to Regulation M.

A. Reasons for the Proposed Action

Based on our experience with the operation of Regulation M, and to reflect market developments since the Regulation's adoption, we propose to revise Regulation M's provisions. The proposed amendments, including amending the definition of ''restricted period,'' requiring recordkeeping for reliance on the *de minimis* transaction exception, updating the restricted period and ''actively-traded'' qualifying thresholds, requiring identification of syndicate covering bids, prohibiting penalty bids, and adopting a new rule to prevent conditioning the award of allocations of offered securities on the receipt of consideration in addition to the stated offering consideration, are designed to modernize Regulation M in light of recent developments while providing clear guidelines to prevent manipulation of the markets.

If the proposed amendments were not adopted, the Regulation may not appropriately address the manipulative abuses that may occur prior to an IPO and that interfere with the securities markets' function as an independent pricing mechanism. Without adjusting the qualifying thresholds for the restricted periods and actively-traded exceptions we could be exempting from the regulations restrictions securities that may be subject to manipulation. Additionally, if the proposed amendments to Rule 101(b)(7) were not adopted, Commission and SRO examiners would be unable to identify possible patterns of abuse or improper policies and procedures that may be in place. As a result of not adopting the proposals contained in rules 104 and 106, investors may be precluded from receiving allocations, paying too high a price for a security or otherwise invest in an offered security (or trade in the aftermarket) with incomplete information as to the true demand for the security and the level or amount of actual syndicate covering activity. Similarly, if distribution participants were not required to disclose to the market and identify or designate when a syndicate short covering bid is made, prospective investors in, and holders of, offered shares will not know the extent

[124] Pub. L. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. and as a note to 5 U.S.C. 601).

[125] 5 U.S.C. 603.

of syndicate covering activity at the time it occurs and may make investment decisions without all the necessary information about the offered security. Additionally, if distribution participants were not prohibited from demanding additional consideration from investors in order to obtain IPO allocations, we would be unable to prophylactically prevent such fraudulent activity from occurring and only reach such activities through the antifraud and anti-manipulation provisions of the federal securities laws. Moreover, if we did not explicitly define IPOs and the restricted period for valuation and election periods, we would not be able to provide certainty to the issuers, distribution participants and others as to the exact application of the rules.

B. Objectives

The proposed amendments to Regulation M are designed to fulfill several objectives. First, the proposed amendments seek to prevent manipulation from occurring by precluding certain activities by underwriters and other distribution participants that can undermine the integrity and fairness of the offering process, particularly with respect to allocations of offered securities. Second, the proposal seeks to enhance the notice and disclosure of certain practices by distribution participants, such as syndicate covering that may affect the market price and trading of an offered security and to prohibit penalty bids. Third, the proposed amendments are designed to prohibit activities that could artificially influence the market for the offered security, including, supporting the offering price by creating the exaggerated perception of scarcity of the offered security or creating the misleading appearance of active trading in the market for the security. The amendments are also intended to update certain definitional and operational provisions in light of market developments since the Regulation's adoption in 1996.

C. Legal Basis

The amendments to Regulation M are proposed pursuant to the authority set forth under the Securities Act, 15 U.S.C. 77a *et seq.*, particularly Section 7, 17(a), 19(a), 15 U.S.C. 77g, 77q(a), and 77s(a); the Exchange Act, 15 U.S.C. 78a *et seq.*, particularly Sections 2, 3, 9(a), 10, 11A(c), 12, 13, 14, 15(c), 15(g), 17(a), 23(a), and 30, 15 U.S.C. 78b, 78c, 78i(a), 78j, 78k–1(c), 78*l*, 78m, 78n, 78o(c), 78o(g), 78q(a), 78w(a), and 78dd–1; and the Investment Company Act, 15 U.S.C. 80a–1 *et seq.*, particularly Sections 23, 30, and 38, 15 U.S.C. 80a–23, 80a–29, and 80a–37.

D. Small Entities Subject to the Rule

Paragraph (a) of Rule 0–10 [126] states that the term ''small business'' or ''small organization,'' when referring to issuers or affiliated purchasers, are those who on the last day of its most recent fiscal year had total assets of $5,000,000 or less. As of 2003, the Commission estimates that there were approximately 3489 issuers that qualified as small entities as defined above, and were subject to Regulation M.[127] Paragraph (c)(1) of Rule 0–10 [128] states that the term ''small business'' or ''small organization,'' when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to § 240.17a–5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. As of 2003, the Commission estimates that there were approximately 905 broker dealers, 33 of which engaged in underwriting, that qualified as small entities as defined above, and were subject to Regulation M.[129] The Commission seeks comment on the number of issuers and broker-dealers that were subject to Regulation M and the number of such issuers, broker-dealers and syndicate members that are small entities.

E. Reporting, Recordkeeping and Other Compliance Requirements

The proposed amendments to Regulation M would impose certain reporting, recordkeeping and other compliance requirements on broker-dealers and issuers who are small entities and engage in securities offerings. Those distribution participants that are small entities who rely on the *de minimis* transactions exception of Regulation M will now be subject to recordkeeping requirements. Also, if any broker-dealers that are small entities undertake syndicate covering transactions they will be subject to the new identification and designation requirements. We do not believe, at this time, that any additional or specialized professional skills will be necessary to achieve these new requirements.

F. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap or conflict with, the proposed amendments.

G. Significant Alternatives

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small issuers and broker-dealers. Pursuant to Section 3(a) of the RFA,[130] the Commission considered the following alternatives: (1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the Rule for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the Rule, or any part thereof, for small entities.

With respect to the proposed amendments to Regulation M, the Commission believes that in order to prevent manipulation and fraud in the offering process and trading markets, uniform rules applicable to all market participants (regardless of size) is necessary. The Commission believes that the majority of entities to whom Regulation M applies and the majority of syndicate members who would be affected by the proposed amendments are not small entities. Therefore, the establishment of different requirements for small entities is not practicable, nor in the public interest and for the protection of investors to do so. In addition, the proposed amendments impose minimal additional costs or burdens so establishing different compliance requirements or clarifying, consolidating, or simplifying compliance or reporting requirements for small entities would not be justified in this context. With regard to the proposed amendments to Regulation M, and clarification of the application of the regulation, small entities would not be specifically exempted, since all securities may be the subject of manipulation or other abuse the amendments seek to prevent. Regulation M imposes performance standards rather than design standards and would require all entities to comply with the

[126] 17 CFR 240.0–10(a).

[127] This number is based on the total number of issuers' 10–KSB filings for the fiscal year ending 9/30/04.

[128] 17 CFR 240.0–10(c)(1).

[129] These numbers are based on OEA's review of 2003 FOCUS Report filings reflecting registered broker dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

[130] 5 U.S.C. 603(c).

rule in order to ensure a proper application of the rule.

H. Solicitation of Comments

The Commission encourages written comments on matters discussed in the IRFA. In particular, the Commission requests comments on (1) the number of issuers and broker-dealers that were subject to Regulation M and the number of such issuers, broker-dealers and syndicate members that are small entities; (2) the nature of any impact the proposed amendments would have on small entities and empirical data supporting the extent of the impact (commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact); and (3) how to quantify the number of small entities that would be affected by and/or how to quantify the impact of the proposed amendments. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves. As discussed above, for purposes of SBREFA, the Commission is also requesting information regarding the potential impact of the proposed amendments on the economy on an annual basis. Commenters should provide empirical data to support their views.

IX. Statutory Basis

The proposed amendments to Rule 17a–2 would be adopted under the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly Sections 2, 3, 9(a)(6), 10(a), 10(b), 13(e), 15(c), 17(a), and 23(a), 15 U.S.C. 78b, 78c, 78i(a)(6), 78j(a), 78j(b), 78m(e), 78o(c), 78q(a), and 78w(a). The proposed amendments to Item 508(*l*)(1) of Regulation S–K and Item 508(j)(1) of Regulation S–B and Rule 481 would be adopted under the Securities Act, 15 U.S.C. 77a *et seq.*, particularly Sections 6, 7, 8, 10, and 19(a), 15 U.S.C. 77f, 77g, 77h, 77j. and 77s(a); the Exchange Act, 15 U.S.C. 78a *et seq.*, particularly Sections 3, 4, 10, 12, 13, 14, 15, 16 and 23; 15 U.S.C. 78c, 78d, 78j, 78*l*, 78m, 78n, 78o, 78p, and 78w; and the Investment Company Act of 1940, 15 U.S.C. 80a–1 *et seq.*, particularly Sections 8 and 38(a), 15 U.S.C. 80a–8 and 80a–37(a). Rules 100, 101, 102, 104, and 106 of Regulation M would be adopted under the Securities Act, 15 U.S.C. 77a *et seq.*, particularly Sections 7, 17(a), 19(a), 15 U.S.C. 77g, 77q(a), and 77s(a); the Exchange Act, 15 U.S.C. 78a *et seq.*, particularly Sections 2, 3, 9(a), 10, 11A(c), 12, 13, 14, 15(c), 15(g), 17(a), 23(a), and 30, 15 U.S.C. 78b, 78c, 78i(a), 78j, 78k–1(c), 78*l*, 78m, 78n, 78o(c), 78o(g), 78q(a), 78w(a), and 78dd–1; and the Investment Company Act of 1940, 15 U.S.C. 80a–1 *et seq.*, particularly Sections 23, 30, and 38, 15 U.S.C. 80a–23, 80a–29, and 80a–37.

Text of Proposed Rule

List of Subjects

17 CFR Part 228

Reporting and recordkeeping requirements, Securities, Small businesses.

17 CFR Parts 229, and 230

Reporting and recordkeeping requirements, Securities.

17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

17 CFR Part 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, the Commission proposes to amend Title 17, chapter II of the Code of Federal Regulations as follows:

PART 228—INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

1. The authority citation for Part 228 continues to read in part as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78*l*, 78m, 78n, 78o, 78u–5, 78w, 78*ll*, 78mm, 80a–8, 80a–29, 80a–30, 80a–37, 80b–11, and 7201 *et seq.*; and 18 U.S.C. 1350.

* * * * *

§ 228.508 [Amended]

2. Section 228.508, paragraph (j)(1), second sentence, is amended by removing the phrase ''penalty bids,''.

PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975—REGULATION S–K

3. The authority citation for Part 229 continues to read in part as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78*l*, 78m, 78n, 78o, 78u–5, 78w, 78*ll*, 78mm, 79e, 79j, 79n, 79t, 80a–8, 80a–9, 80a–20, 80a–29, 80a–30, 80a–31(c), 80a–37, 80a–38(a), 80a–39, 80b–11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

§ 229.508 [Amended]

4. Section 229.508, paragraph (l)(1), second sentence, is amended by removing the phrase ''penalty bids,''.

PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

5. The authority citation for Part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z–3, 77sss, 78c, 78d, 78j, 78*l*, 78m, 78n, 78o, 78t, 78w, 78*ll*(d), 78mm, 79t, 80a–8, 80a–24, 80a–28, 80a–29, 80a–30, and 80a–37, unless otherwise noted.

* * * * *

§ 230.481 [Amended]

6. Section 230.481, paragraph (d)(1), third sentence, is amended by removing the phrase ''penalty bids,''.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

7. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

8. Amend § 240.17a–2 by:

a. Removing the authority citation following the section;

b. Removing the phrase ''or imposes a 'penalty bid,' as defined in § 240.100 of this chapter'' in the introductory text of paragraph (a);

c. Revising the introductory text of paragraph (c);

d. Removing the phrase ''or a penalty bid has been imposed'' in paragraph (c)(1)(i);

e. Removing the phrase '', and whether any penalties were assessed'' in paragraph (c)(1)(ii);

f. Adding the word ''and'' at the end of paragraph (c)(i)(iii);

g. Removing the ''; and'' and in its place adding a period at the end of paragraph (c)(1)(iv); and

h. Removing paragraph (c)(i)(v).

The revision reads as follows:

§ 240.17a–2 Recordkeeping requirements relating to stabilizing activities.

* * * * *

(c) *Records relating to stabilizing and syndicate covering transactions required to be maintained by manager.* Any person subject to this section who acts as a manager and stabilizes or effects syndicate covering transactions shall:

* * * * *

9. Section 240.17a–4 is amended by adding paragraph (b)(13) to read as follows:

§ 240.17a–4 Records to be preserved by certain exchange members, broker and dealers.

* * * * *

(b) * * *

(13) The record(s) required to be made pursuant to § 242.101(b)(7) of this chapter.

* * * * *

PART 242—REGULATIONS M, SHO, ATS, AND AC AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

10. The authority citation for Part 242 is revised to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k–1(c), 78*l*, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd–1, 78mm, 80a–23, 80a–29, and 80a–37.

11. Section 242.100 is amended by:

a. Revising the phrase ''(§§ 242.100—242.105 of this chapter)'' to read ''(§§ 242.100 through 242.106)'' in paragraph (a);

b. Revising the phrase ''(§§ 242.100 through 242.105 of this chapter)'' to read ''(§§ 242.100 through 242.106)'' in paragraph (b);

c. Adding the following definitions in alphabetical order: Election period; Initial public offering; and Valuation period; and

d. Revising the definition of *Restricted period.*

The revision and additions read as follows.

§ 242.100 Preliminary note; definitions.

* * * * *

Election period means any period during which shareholders have the right to elect among various forms of consideration offered in a distribution.

* * * * *

Initial public offering (IPO) means:

(1) An issuer's first offering of a security to the public in the United States, and

(2) 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.

* * * * *

Restricted period means the period beginning:

(1) For any security with an ADTV value of $120,000 or more of an issuer whose common equity securities have a public float value of $30 million or more, the period beginning on the later of one business day prior to the determination of the offering price or such time that a person becomes a distribution participant, and ending upon such person's completion of participation in the distribution.

(2) For any security with an ADTV value of less than $120,000 of an issuer whose common equity securities have a public float value of less than $30 million, the period beginning on the later of five business days prior to the determination of the offering price or such time that a person becomes a distribution participant, and ending upon such person's completion of participation in the distribution.

(3) In the case of a distribution involving a merger, acquisition, or exchange offer:

(i) The day proxy solicitation or offering materials are first disseminated to security holders and ending upon the completion of the distribution;

(ii) The period one or five business days prior to the commencement of any valuation period and for the duration of such period (refer to paragraphs (1) and (2) of this definition to determine if one or five business days is applicable); and

(iii) The period one or five business days prior to the commencement of any election period and for the duration of such period (refer to paragraphs (1) and (2) of this definition to determine if one or five business days is applicable).

(4) In the case of a distribution involving an IPO, the earlier of:

(i) The period beginning at the time when the issuer reaches an understanding with the broker-dealer that is to act as an underwriter, or such time that a person becomes a distribution participant, and ending upon the issuer's or distribution participant's completion of participation in the distribution; or

(ii) 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 ending upon the issuer's or distribution participant's completion of participation in the distribution.

* * * * *

Valuation period means any period during which the market price of the offered security is a factor in determining the consideration to be paid in the distribution.

12. Amend § 242.101 by revising paragraph (b)(7) and in paragraph (c)(1) by revising the phrases ''$1 million'' and ''$150 million'' to read ''$1.2 million'' and ''$180 million'' respectively.

§ 242.101 Activities by distribution participants.

* * * * *

(b)(7) *De minimis transactions.* 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, or unaccepted bids: *Provided, however,* that the person making such bid or purchase has maintained and enforces written policies and procedures designed to achieve compliance with other provisions of this section. Any person relying on this exception shall create a separate record specifying:

(i) The security that is the subject of the relevant distribution;

(ii) The day the restricted period commenced;

(iii) The ADTV;

(iv) The bid or purchase that occurred during the restricted period, including time, price, quantity, and market;

(v) The individual who made such bid or purchase and the system used to make such bid or purchase;

(vi) How and when such bid or purchase was discovered;

(vii) The policies and procedures designed to achieve compliance with this section in effect at the time of such bid or purchase;

(viii) The review of the policies and procedures performed following the discovery of such bid or purchase; and

(ix) Any modifications made to those policies and procedures. A broker or dealer shall preserve the record specified in this paragraph in accordance with § 240.17a–4(b)(13) of this chapter; or

* * * * *

13. Amend § 242.102, paragraph (d)(1), by revising the phrases ''$1 million'' and ''$150 million'' to read ''$1.2 million'' and ''$180 million'' respectively.

14. Amend § 242.103, paragraph (b)(7), by revising the phrase ''§§ 228.502, 228.508, 229.502, and 229.508'' to read ''§§ 228.508 and 229.508''.

15. Amend § 242.104 by:

a. Revising paragraphs (a), (h)(2), and the introductory text of paragraph (j)(2); and

b. In paragraph (h)(3) revise the phrase ''Item 502(d) of Regulation S–B (§ 228.502(d) of this chapter) or Item 502(d) of Regulation S–K (§ 229.502(d) of this chapter)'' to read ''§ 230.481(d) of this chapter''.

The revisions read as follows.

§ 242.104 Stabilizing and other activities in connection with an offering.

(a) *Unlawful activity.* It shall be unlawful for any person, directly or indirectly, to stabilize or to effect any syndicate covering transaction in connection with an offering of any security, in contravention of the provisions of this section. No stabilizing shall be effected at a price that the person stabilizing knows or has reason to know is in contravention of this section, or is the result of activity that is fraudulent, manipulative, or deceptive under the securities laws, or any rule or regulation thereunder. It shall be unlawful for any person to impose or assess a penalty bid in connection with an offering.

* * * * *

(h) * * *

(2) Any person communicating a bid that is for the purpose of effecting a syndicate covering transaction shall:

(i) Identify or designate the bid as such wherever it is communicated; and

(ii) Provide prior notice to the self-regulatory organization with direct authority over the principal market in the United Sates for the security for which the syndicate covering transaction is effected.

* * * * *

(j) * * *

(2) *Transactions of Rule 144A securities.* Transactions in securities eligible for resale under § 230.144A(d)(3) of this chapter, or any reference security, if such securities are offered or sold in the United States solely to:

* * * * *

16. Add § 242.106 to read as follows:

§ 242.106 Allocating offered securities.

(a) *Unlawful activity.* It shall be unlawful for a distribution participant, issuer or their affiliated purchasers, directly or indirectly, acting either alone or in concert with another person, to attempt to induce, induce, solicit, require, or accept from a potential purchaser of an offered security in connection with an allocation of the offered security, any consideration for such offered security in addition to that stated in the registration statement filed under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) or applicable offering document for the offer and sale of such offered security.

(b) *Exemptive authority.* Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any person or class of persons, to any transaction or class of transactions, or to any security or class of securities to the extent that such exemption is necessary or appropriate, in the public interest, and is consistent with the protection of investors.

Dated: December 9, 2004.

By the Commission.

J. Lynn Taylor,

Assistant Secretary.

[FR Doc. 04–27434 Filed 12–16–04; 8:45 am]

BILLING CODE 8010–01–P