

## SEC Proposes Amendments to Regulation M

The SEC has proposed amendments to Regulation M under the Securities and Exchange Act of 1934 (the “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:

- amend the definition of “restricted period” with respect to IPOs (defined below) so that the restricted period begins on 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 SEC or other offering document is first circulated to potential investors, or such time that a person becomes a distribution participant;
- expressly reflect the SEC’s long-standing application of the definition of restricted period in the context of mergers, acquisitions and exchange offers to include valuation and election periods;
- amend the “*de minimis* exception” to require recordkeeping of such transactions;
- update the average trading volume value (the “ADTV”) and public float value qualifying thresholds for purposes of the restricted period definition and the actively traded securities and actively-traded reference securities exceptions;
- enhance the transparency of syndicate covering bids;
- prohibit the use of penalty bids;
- include reference securities in the exception for transactions in securities eligible for resale under Rule 144A; and
- adopt a 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.

The proposed amendments are subject to a 60-day comment period.

---

1285 Avenue of the Americas  
New York, New York 10019-6064  
(212) 373-3000

1615 L Street, NW  
Washington, DC 20036-5694  
(202) 223-7300

Alder Castle, 10 Noble Street  
London EC2V 7JU England  
(44-20) 7367 1600

Fukoku Seimei Building 2nd Floor  
2-2, Uchisawaicho 2-chome  
Chiyoda-ku, Tokyo 100, Japan  
(81-3) 3597-8120

Oriental Plaza, Tower E3, Ste. 1205  
No. 1, East Chang An Avenue  
Beijing 100738, People’s Republic of China  
(86-10) 8518-8828

12th Fl., Hong Kong Club Building  
3A Chater Road, Central  
Hong Kong  
(852) 2536-9933

## Background

Regulation M was adopted to regulate activities that offering participants could use to manipulate the price of an offered security. Specifically, Regulation M, among other things, prohibits issuers, selling security holders, underwriters, broker-dealers and other distribution participants 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. In contrast to the general antifraud and anti-manipulation provisions of the federal securities laws, Regulation M is focused on prohibiting particular activities in connection with securities offerings and generally precludes certain persons from engaging in specified market activities. 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.

## Proposed Amendments to Regulation M

### *“Restricted Period”*

The “restricted period” under Regulation M is the period of time 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. Under the current rules, the restricted period is based upon the ADTV and the value of the public float and commences on either one or five-days prior to the determination of the offering price or such time that a person becomes a distribution participant. (The ADTV and public float thresholds are discussed in more detail below.) Due to the absence of a trading market for IPOs, the longer, five-day restricted period currently applies to IPOs.

The SEC believes that the current rules are 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. Because there is no trading market that would provide an independent pricing mechanism for prospective investors to evaluate the IPO price set by underwriters, any inducement activity by the underwriters or other distribution participants can have long-lasting effects. The SEC is therefore proposing to amend the definition of “restricted period” in Rule 100(b) with respect to IPOs by adding a new paragraph (4) to provide that the restricted period for an IPO would extend from the earlier of: (a) 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 (b) if there is no underwriter, the period beginning at the time the registration statement is filed with the SEC or other offering document is first circulated to potential investors, or such time that a person is a distribution participant, and would conclude when the distribution is completed.

For purposes of Regulation M, “IPO” means 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, an issuer’s first offering of an equity security to the public in the United States. Under the proposed definition, 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. 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 the one or five-day restricted period would apply based on such ADTV and public float values. The SEC also noted in the proposing release that the actively-traded security and reference-security exceptions would not apply to IPOs.

*“Restricted Period” for mergers, acquisitions and exchange offers*

Under the current rules, the restricted period for mergers, acquisitions and exchange offers begins on the day proxy solicitation or offering materials are first disseminated to security holders. The SEC has a long-standing interpretation that the restricted period for mergers, acquisitions and exchange offers includes valuation and election periods. “Valuation period” refers to time periods when the offered security’s market price is a factor in determining the consideration paid in the corporate action. “Election period” refers to the time periods when shareholders have the right to elect among various forms of consideration. These periods are deemed part of the distribution because valuation and election periods are price-sensitive times during which the incentive for interested persons to manipulate is high. As a result, the SEC is proposing to amend the definition of restricted period for mergers, acquisitions and exchange offers to specifically include valuation and election periods.

*ADTV and public float value thresholds*

As noted above, the restricted period generally is based upon the ADTV and public float of the issuer. The SEC is proposing to increase the thresholds for actively-traded securities and actively-traded reference securities in order to adjust for inflation since Regulation M’s adoption in 1996. The proposed thresholds are designed 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).

The table below provides the current and proposed thresholds.

	Current Threshold		Proposed Threshold	
	ADTV	Public Float	ADTV	Public Float
Actively-Traded Reference Securities	\$100,000	\$25 million	\$120,000	\$30 million
Actively-Traded Securities	\$1 million	\$150 million	\$1.2 million	\$180 million

If the ADTV or public float falls below the Actively-Traded Reference Securities threshold, the restricted period begins on the later of five days prior to the determination of the offering price or such time the person becomes a distribution participant. If the ADTV and public float meet the Actively-Traded Reference Securities threshold, the restricted period begins on the later of one day prior to the determination of the offering price or such time the person becomes a distribution participant. If the ADTV and public float meet the Actively Traded Securities threshold, there is no restricted period.

#### *De minimis exception*

The *de minimis* exception in Rule 101(b)(7) is intended to excuse from the trading prohibitions of Regulation M, small, inadvertent transactions that would not impact the market. The exception currently covers purchases and unaccepted bids during the restricted period that total less than 2% of the distributed security's ADTV if the person making the bid or purchase maintains and enforces written policies and procedures reasonably designed to achieve compliance with Regulation M. A company is expected to review its policies and procedures and modify them as appropriate.

The SEC is proposing to require companies to create a separate record of each bid or purchase that is made in reliance on the *de minimis* exception, which requires, among other things, that brokers and dealers specify the subject security, the day the restricted period commenced, the ADTV and the bids and 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). This requirement is intended to more easily allow the SEC and SRO examiners to uncover patterns of abuse or policies and procedures that are not reasonably designed to achieve compliance with the rule.

#### *Syndicate covering transactions*

The SEC is proposing to regulate syndicate covering transactions in the same manner stabilization activities are currently regulated under Rule 104 of Regulation M. 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 short position created in connection with the offering. Syndicate covering transactions 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. The current rules relating to stabilizing bids require prior notification to the market on which such bids are effected and to the person with whom the bid is entered. The current rules relating to syndicate covering transactions only require prior notification to the relevant SRO. Issuers are also 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 the underwriter intends to engage in these activities.

To address the disparate treatment of activities under Rule 104, the SEC is proposing to require any person communicating a bid for the purpose of effecting a syndicate covering transaction to identify and designate the bid as such whenever it is communicated. The SEC believes that the proposed rules will protect investors by requiring syndicate covering bids to be identified or designated thereby providing contemporaneous information about the potential market impact of syndicate bidding and purchasing activity. The SEC is not, however, proposing to apply the type of specific price, counter-party disclosure or other limitations that currently apply to stabilizing transactions.

#### *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. Penalty bids, like syndicate covering transactions, may have the effect of stabilizing the market price of an offered security. The proposing release identified three potential concerns relating to the use of penalty bids. First, 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, a salesperson may improperly interfere with a customer’s right to sell securities when the customer chooses to do so due to the salesperson’s fear of losing commissions. Third, the SEC stated there is evidence that the assessment of penalty bids results in discriminatory effects on the syndicate customers as institutional customers are typically not penalized but retail salespersons are penalized.

The SEC is proposing to prohibit all penalty bids by adding a new subparagraph under Rule 104 which states, “it shall be unlawful to impose or assess any penalty bid in connection with an offering.” The SEC also proposes to eliminate the existing references to penalty bids in the current Regulation M, relevant provisions of the Exchange Act (Rule 17a-2(c)) and Securities Act (Rule 481(d)) and Regulations S-K and S-B (Item 508(l)).

*Exception for transactions in Rule 144A securities*

Rule 104 generally excepts transactions in Rule 144A securities offered or sold in the U.S., provided that they are sold either to qualified institutional buyers in a transaction exempt from registration or to non U.S. persons in Regulation S offerings that are made concurrently with a Rule 144A offering. This exception is meant to be identical to exemptions for transactions in 144A securities contained in Rules 101 and 102 of Regulation M. The SEC therefore proposes to add the phrase “or any reference security”<sup>1</sup> to Rule 104 to make this subparagraph consistent with Rules 101 and 102.

*Prohibition on accepting consideration in addition to the stated offering price of a security (new Rule 106)*

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

New Rule 106 is designed to prohibit previous abuses such as conditioning or “tying” an allocation of shares in a “hot issue” on an understanding that the customer would buy shares in another, usually “cold” offering, or on paying excessive commissions to the underwriter. Rule 106 would apply to any distribution of securities, whether a public offering or private placement of securities or an initial or secondary offering. This new rule is an attempt to address a broad range of conduct by distribution participants and issuers that can stimulate the market of the offered shares, thereby distorting the offering price in the aftermarket. The new rule would also 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. The SEC stated in the proposing release that this new rule is not intended to interfere with legitimate customer relationships, such as allocating IPO shares to a customer because the customer has separately retained the firm for other services, provided, the customer has not paid excessive compensation in relation to those services.

\* \* \*

This memorandum provides only a general overview of the proposed rules. It is not intended to provide or constitute legal advice, and no legal or business decision should be based on its contents. Any questions

---

<sup>1</sup> Reference security means 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.

concerning the foregoing should be addressed to members of the Paul Weiss Securities Group (see below). In addition, memoranda on related topics may be accessed in the Securities Group—Publications section of our web site ([www.paulweiss.com](http://www.paulweiss.com)).

Mark S. Bergman	(44 20) 7367 1601	Edwin S. Maynard	(1) 212-373-3024
Richard S. Borisoff	(1) 212-373-3153	Raphael M. Russo	(1) 212-373-3309
Andrew J. Foley	(1) 212-373-3078	Lawrence G. Wee	(1) 212 373 3052
Paul D. Ginsberg	(1) 212-373-3131	Tong Yu	(81 3) 3597 6303
John C. Kennedy	(1) 212-373-3025		