Securities Industry Association
120 Broadway - 35 Fl. • New York, NY 10271-0080 • (212) 608-1500, Fax (212) 968-0703 • www.sia.com, info@sia.com

February 15, 2005

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: File No. S7-41-04; Amendments to Regulation M

Dear Mr. Katz:

The Capital Markets Committee of the Securities Industry Association ("SIA")[1] appreciates the opportunity to comment on the proposed amendments to Regulation M,[2] the anti-manipulation rules concerning securities offerings.

For over 60 years, the SEC has sought to strike a fine balance in the rulemaking process. Carefully tailored rules should serve both to protect investors and to promote the efficiency and competitiveness of the U.S. capital markets. The proposed amendments to Regulation M represent the Commission's most recent effort to balance these sometime competing objectives. Because of the importance of these objectives to the SEC's mission and to the entire capital-raising system in the U.S., any proposed changes must be subjected to the highest level of scrutiny. Rules that are unclear or overly broad can adversely impact the ability of issuers to raise capital through an efficient distribution of securities and the willingness of investors to risk their capital in the new issue context.

For the most part, SIA believes the proposed amendments reflect a careful weighing of these objectives. SIA supports the proposal to amend Rule 101's "*de minimis* exception" to require recordkeeping, the proposal to amend the definition of the restricted period as it relates to IPOs, the proposal to amend Rule 104 to include reference securities in the exception for transactions in securities eligible for resale under Rule 144A, and the proposal to update the average daily trading volume (ADTV) and public

[1] The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry employs 790,600 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated $213 billion in domestic revenue and an estimated $283 billion in global revenues. (More information about SIA is available at: www.sia.com.)

[2] Securities Exchange Act Release No. 50831 (December 9, 2004), 69 Fed. Reg. 75773.

float thresholds for purposes of the "restricted period" definition and the "actively-traded" securities and "actively-traded" reference securities exceptions.

SIA believes, however, that some of the proposals are vague and overbroad, and would threaten the delicate balance that has been achieved. We are particularly concerned about proposed Rule 106, which we believe sweeps far too broadly and lacks clarity and certainty. SIA is concerned about the impact that this lack of clarity and certainty would pose for legitimate information gathering in the price discovery and allocation process. In addition, SIA believes that the requirement to disclose syndicate covering bids will disrupt legitimate efforts on the part of underwriters to act in the interests of long-term investors by providing liquidity in the often volatile trading environment that exists in the wake of a distribution of securities. SIA addresses each of the proposals below.

Rule 106 – Proposed Rule 106 would expressly prohibit distribution participants, issuers or affiliated purchasers from "attempting to induce," "inducing," "soliciting," "requiring" or "accepting" from a potential purchaser of an offered security any consideration in addition to the price stated in the applicable offering document.

COMMENT **–** SIA believes that "consideration in addition to that stated in the applicable offering document" is an overly broad and vague standard and will expose firms to random and inconsistent enforcement interpretations.

SIA supports rules prohibiting *quid pro quo* arrangements where the specific behavior that is sought in return for the allocation is identified and conditioned on or tied to the allocation. In this regard, SIA notes its previous support for the recommendations of the NASD/NYSE IPO Advisory Committee , which recommended strengthening prohibitions on unlawful quid pro quo allocations, including allocations as consideration or in exchange for excessive compensation from customers, or for purchases of shares in the aftermarket. Moreover, SIA expressed support for SRO proposals that likewise sought to ban IPO allocations in return for excessive commissions, promises of aftermarket purchases, and agreements to steer investment banking business to the underwriter. SIA believes these prohibitions on identified quid pro quo activities strike an appropriate balance between deterring manipulation and providing firms with fair notice of the activity that is deemed to be manipulative.

"Consideration" is a broad concept that could be used to describe virtually any benefit, including general enhancement of a long-term business relationship that might be derived from a decision to allocate securities to a client. As such, it fails to meet the SEC's own stated goal for "a rule *specifically directed at the types of impermissible conduct* discussed herein." (Proposal, p.75785) The use of "consideration" also fails to capture the distinction the SEC claims it is drawing between factors that may legitimately be considered by an underwriter in the allocation process and "excessive compensation in relation to [services provided]." (Id.) As the SEC release notes in the narrative discussion of proposed Rule 106, the proposal is "not intended to interfere with legitimate customer relationships." However, the proposed rule itself is drafted in such broad terms that it calls into question (and would support regulatory inquiry into) virtually any relationship-based factor that an underwriter might consider in the allocation process.

The rule, as proposed, is also overbroad in that it would apply to any distribution of securities, *i.e.*, debt as well as equity offerings, private placements as well as public offerings, and follow-on offerings as well as IPOs. SIA does not support application of the proposal to debt offerings, private placements or follow-on equity offerings. The record does not cite any abuses in connection with offerings of these securities and we believe that the SEC should narrow the proposal to address only the perceived abuses that prompted the rulemaking.

We note in this regard that the potential for abuse only exists in the context of an offering where investors believe that the securities will trade at a significant premium in the aftermarket – in other words, a "hot" issue. Only where an allocation is widely perceived to be likely to trade at a significant premium is there the potential for a *quid pro quo* involving additional consideration. This is the same context in which there is a concern about "free riding," the potential for abuse addressed by NASD Rule 2790. When the NASD adopted Rule 2790, it gave substantial consideration to the question of scope and concluded that non-IPO categories of offerings present virtually no risk of free riding abuse because there is virtually no likelihood of a non-IPO constituting a "hot" issue.[3] The absence of any evidence of abuse outside the IPO context strongly argues for limiting proposed Rule 106 to IPOs.

Rule 104 – The proposals would amend Rule 104 to require disclosure of syndicate covering bids.

<u>COMMENT</u> - SIA believes the proposal to require disclosure of syndicate covering bids would lead to significant market confusion on the part of investors and heighten the risks to underwriters, issuers and long-term investors during the critical first hours of trading in a newly launched security. Trading in the after-market for a new security is active and sometimes volatile as the market attempts to balance buying and selling interests. Legitimate buying activity on the part of the syndicate during this period serves the regulatory purpose of providing liquidity and facilitating a fair and orderly aftermarket. The proposed disclosures would undermine the efforts of the syndicate managers in this regard by revealing to market participants, including accounts engaged in short-term and speculative trading strategies, the exact actions being taken by the syndicate to facilitate an orderly aftermarket. Contemporaneous disclosure of syndicate short-covering bids would work to the advantage of short-term traders and arbitrageurs, who could find profit by trading against the syndicate. This would exacerbate volatility in the early aftermarket and reward market opportunists at the expense of long-term investors.

[3] Securities Exchange Act Release No. 48701 (October 24, 2003), 68 Fed. Reg. 62126.

In the release, the SEC refers to syndicate short-covering as "stabilization-like activity," and we are concerned that the release may blur the clear and important distinction between short-covering and stabilization. Syndicate short-covering and Rule 104 stabilization are quite different and should continue to be treated quite differently under Regulation M. In stabilization conducted pursuant to Rule 104, the syndicate bids for and purchases securities for long account. These purchases occur before the syndicate completes the distribution of the offered securities[4] and are made for the purpose of holding the price of the security at a level that might not otherwise prevail in the market. Rule 104 stabilization is, in effect, a legally sanctioned exception to the general prohibition against manipulation, and must comply with rigorous and detailed rules regarding price levels and disclosure.

Syndicate short-covering, in contrast, does not involve any attempt to hold the price of a security at an artificially high trading level. To the contrary, it is a means of facilitating an orderly aftermarket and providing liquidity as a newly issued security settles into its natural trading level. Short-covering generally occurs after the distribution is complete - it is not effected in connection with pricing the distribution - and only to the extent that the underwriters have made over-allotment sales. The practice of over-allotting allows underwriters to provide liquidity in the early aftermarket, when trading may be especially active and volatile, without the need to purchase securities for long account. This works to the benefit of long-term investors, as the syndicate manager is able to absorb some of the flipping of shares that may, and often does, occur in the early aftermarket. The practice of over-allotting an offering is well-established, widely accepted in the marketplace and fully disclosed in the prospectus.

Given the very significant distinctions between Rule 104 stabilization and syndicate short-covering, and given the potentially harmful impact of the proposal on the ability of underwriters to facilitate an orderly aftermarket, we do not believe it is necessary or appropriate to require contemporaneous disclosure of short-covering bids. If the SEC nevertheless believes that additional transparency is necessary in this area, we suggest as an alternative that the SEC consider a post-syndicate short covering disclosure requirement. Foreign regulators have opted for such an approach after rejecting real-time disclosure for short covering activity. For example, the initial EU proposal set out in a June 2001 Consultation paper issued by the Forum of European Securities Commissions (now known as the Committee of European Securities Regulators or "CESR") would have required disclosure of all short covering transactions. Market participants commenting on the proposal noted that disclosure of this information may be confusing to the market and investors and would impact the efficacy of these activities if managers were forced to reveal their hand. CESR subsequently dropped the bid disclosure requirement in favor of disclosure after the short-covering period. These new rules will come into force this year when the Market Abuse Directive is implemented.

---

[4] In rare circumstances, a syndicate may complete a distribution, or even establish a syndicate short position, before purchasing shares for stabilization purposes, but in the vast majority of cases, stabilization takes place only prior to the completion of the distribution.

Similarly, in 2002, the Hong Kong Securities and Futures Commission (SFC) invited public comment on whether a lead manager should identify and disclose its short-covering bids to the market in the course of short covering actions. Most commenters objected to the idea of "flagging" bids and believed that flagging would convey a negative message to the market as to the performance of the offer and defeat the purposes that the stabilizing (short covering) bids seek to achieve. The SFC ultimately decided to require disclosure of stabilization (short covering) activity within seven days from the end of the stabilizing period. In support of this conclusion, the SFC explained that it settled on a post-stabilization disclosure approach in order to "strike a balance between market transparency and the potentially damaging effects of flagging on the stabilizing efforts."[5]

Finally, SIA believes that the proposal does not address the significant operational challenge of how syndicate short-covering bids would be flagged. The SEC's Regulation NMS proposals can be anticipated to result in a broader and more de-centralized dissemination of quotes, including bids. Given these proposed changes, it is going to be difficult and costly to implement the multiple connectivity channels necessary to designate syndicate-covering bids. Also, given that syndicate short covering can be conducted during periods of time in which the underwriter is also conducting customer facilitation or other principal trading for its own account, the rule could necessitate a continuous placement and removal of the syndicate "flag", which is enormously time-consuming and cumbersome and could result in the underwriter's inability to access the market at certain times.

Rule 102 – Proposal to prohibit penalty bids.

<u>COMMENT</u> - Despite the fact that the penalty bid is rarely used today outside of the context of offerings of closed-end funds, where it plays a critical role, SIA is concerned that the proposed ban amounts to a rejection of longstanding policy permitting underwriters to engage in practices that facilitate an orderly aftermarket. Penalty bids have for years been an acknowledged and accepted means of countering the artificial selling pressure brought to bear by excessive flipping and helping a new issue find its natural equilibrium price.

Through 60 years of SEC and Court pronouncements, flipping has been found to artificially depress stock prices in the aftermarket and disrupt the efficient distribution of the stock.[6] In adopting Regulation M, the SEC recognized that "[o]ne of the objectives of a penalty bid is to encourage syndicate participants to sell the securities to those persons who intend to hold them rather than engage in short-term profit-taking, *i.e.*, to combat

[5] We note that while CESR and the SFC use the term "stabilization" in their proposals, that term is often used outside the US to refer broadly to both syndicate short covering activities as well as Rule 104 stabilization.
[6] <u>Friedman v. Salomon Smith Barney</u>, 2000 WL 1804719 (S.D.N.Y.)

flipping." (Regulation M Proposing Release at 1740). The SEC also noted that "underwriters ... have an incentive to provide 'support' in the aftermarket to counterbalance pressure on the security's price from 'flipping' and other selling activity that could adversely affect the investors who have purchased the offering." (*id.* at 1739).

SIA is concerned that the proposed prohibition of penalty bids represents a reversal of a longstanding policy goal of permitting actions to combat flipping in order to ensure the efficient distribution of shares to the public. It is not clear from this proposal that there is an equally compelling policy goal supporting the elimination of the penalty bid, and that doing so could signal a reduced role for competitive concerns and efficient distributions in the SEC's careful balancing act.[7]

The only investor protection concern that was previously raised in connection with penalty bids is the discriminatory application of the penalty bid. The NASD/NYSE IPO Advisory Committee convened by the SEC recommended banning discriminatory application of the penalty bid, but did not go as far as suggesting a total ban on the bid itself. The recently filed NASD and NYSE rules governing pricing and allocation practices likewise follow these recommendations.[8]

The SEC ought to reaffirm its recognition of the importance of the efficient distribution of shares in the capital formation process and its historical support for measures that combat efforts to disrupt it.

SIA is particularly concerned that the elimination of penalty bids will be disruptive to initial public offerings of closed-end registered investment companies ("closed-end funds"). Typically, closed-end funds offer an unlimited number of shares to meet all public demand and therefore may be distinguished from offerings for which there is relatively low demand of the type noted in the proposing release. In addition, as newly created and capitalized entities, there is no operating history to instigate meaningful appreciation of the shares immediately after their initial issuance. These two factors make it unlikely that investors would have any legitimate investment rationale for buying shares in the new issue and quickly selling them. As a result, underwriters impose a syndicate bid for a period of 30 to 45 days after the offering to enable the closed-end fund to invest its proceeds and establish an operating history. Absent a penalty bid, intermediary brokers or dealers may immediately sell shares purchased in the IPO into the syndicate bid at or near the original offer price thereby retaining the sales commission at little or no risk to the client's capital.

The penalty bid mechanism has proven to be highly effective at helping to ensure and establish an efficient and orderly market for newly listed shares. The penalty bid process ensures that a more accurate level of legitimate demand is determined in the

---

[7] "The Regulation of 'Pegging Fixing and Stabilizing' of Securities Prices." SEC Release No. 34- 2446 (March 18, 1940) ("1940 Statement").
[8] Securities Exchange Act Release No. 50896 (December 20, 2004), 69 Fed. Reg. 77804.

offering process, thereby protecting investors from the downward price pressure flipping would otherwise cause. Should the penalty bid be eliminated, we believe there would be no effective check on flipping to the detriment of closed-end funds and long-term investors and potentially impair the creation of new closed-end funds. Thus, should the rule be adopted, SIA believes the SEC should specify definitionally that the shares covered include common stock in an initial public offering, other than one made by an investment company under the Investment Company Act of 1940.

Rule 100 – The proposed amendments to Rule 100 would amend the definition of "restricted period" with respect to IPOs and expressly reflect the Commission's long-standing application of the definition in the context of mergers, acquisitions, and exchange offers.

<u>COMMENT</u> - SIA supports the SEC's effort to clarify the term of the restricted period. In SIA's view, however, it is far more critical to provide the market with clear guidance as to the manipulative behavior that falls under the rule. SIA believes there is an urgent need for greater clarity in distinguishing between legitimate information gathering in the price discovery and allocation process and impermissible solicitation of aftermarket purchases.

Rule 101 – The proposal would amend Rule 101's "*de minimis* exception" to require recordkeeping.

<u>COMMENT</u> - SIA supports the proposal.

Rule 104(j)(2) - The proposal would amend Rule 104 to include reference securities in the exception for transactions in securities eligible for resale under Rule 144A.

<u>COMMENT</u> - SIA supports the proposal.

Rules 100, 101, and 102 – The proposal would 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.

<u>COMMENT</u> - SIA supports the proposal.

CONCLUSION

The Committee appreciates very much this opportunity to present our views. Should you have any questions, please feel free to communicate with our SIA staff advisor Scott Kursman, Vice President & Associate General Counsel of SIA, at (212) 618-0508. We would be happy to arrange a meeting between the Staff and members of the Capital Markets Committee to explain our views more thoroughly.

Very truly yours,

John Faulkner, Chairman
SIA Capital Markets Committee

cc: The Honorable William H. Donaldson, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
Giovanni Prezioso, General Counsel, Office of General Counsel
Alan Beller, Director, Division of Corporation Finance
Annette L. Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Larry Bergmann, Senior Associate Director, Division of Market Regulation
James Brigagliano, Assistant Director, Division of Market Regulation
Joan Callopy, Special Counsel, Division of Market Regulation
Elizabeth Sandoe, Special Counsel, Division of Market Regulation
Liza Orr, Special Counsel, Division of Market Regulation
Elizabeth Marino, Special Counsel, Division of Market Regulation
Denise Landers, Special Counsel, Division of Market Regulation