ABA

AMERICAN BAR ASSOCIATION

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Section of Business Law
321 North Clark Street
Chicago, Illinois 60610
(312) 988-5588
FAX: (312) 988-5578
email: businesslaw@abanet.org
website: www.abanet.org/buslaw

March 8, 2005

By email: rule-comments@sec.gov

Securities and Exchange Commission
450 Fifth Street NW
Washington, D.C. 20549-0609
Attention: Jonathan G. Katz, Secretary

Re: File No. S7-41-04

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law (the "Committee")[1] and was prepared by the Committee's Market Regulation Subcommittee in response to the Securities and Exchange Commission's request for comments on proposed amendments to Regulation M.[2]

The comments expressed in this letter represent the views of the Committee only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and, therefore, do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it

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[1] References in this letter to "we" and "our" mean the Committee.

[2] Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings, Securities Act Release No. 8511, Securities Exchange Act Release No. 50831, Investment Company Act Release No. 26691 (Dec. 9, 2004), 69 Fed. Reg. 75774, 75783 (Dec. 17, 2004) (the "Proposing Release").

necessarily reflect the views of all members of the Committee. This letter also does not represent the views of any other ABA Section.

The Committee commends the Commission for its efforts to update Regulation M and appreciates the opportunity to comment on the proposed amendments. We agree that there is a need for Regulation M to be updated to address conduct not contemplated when it was adopted, as described in the NYSE/NASD IPO Advisory Committee Report.[3] Accordingly, we support the proposed amendments in many respects. In particular, we support the following proposals: (1) amending Rule 101's *de minimis* exception to require recordkeeping, and (2) updating Regulation M's dollar amount thresholds. The Committee, however, respectfully disagrees with the broad applicability and vagueness of certain aspects of the proposed rules, and in particular Rule 106.

We comment below on those aspects of the proposal that raise the most significant issues.

Discussion

Proposed Rule 106

Proposed Rule 106 would prohibit distribution participants, issuers, or affiliated purchasers from directly or indirectly "attempting to induce," "inducing," "soliciting," "requiring," or "accepting" from a potential purchaser of an offered security in connection with an allocation of the offered security, "any consideration" in addition to that stated in the registration statement or applicable offering document for the sale of such security. The proposal is designed to prohibit both "tying" and *quid pro quo* arrangements.

Comments Regarding Covered Offerings

We strongly believe that the rule, as drafted, is over-broad. In the Proposing Release, the Commission proposed the rule revisions on the basis of certain misconduct in connection with IPOs. However, as the Proposing Release acknowledges, the rule "would apply to any distribution of securities, *i.e.*, a public offering or private placement, and would apply equally to initial and secondary offerings."[4] We believe that, in the absence of demonstrated abusive conduct, additional regulation is not necessary or appropriate other than for initial public

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[3] The IPO Advisory Committee was established at the request of the SEC in August 2002 to review the IPO process and recommend ways to address problems evidenced in the "hot IPO" period of the late 1990s. The IPO Advisory Committee issued its final report in May 2003. *See* NYSE/NASD IPO Advisory Committee, Report & Recommendations (May 2003), *available at* http://www.nyse.com/pdfs/iporeport.pdf ("IPO Advisory Committee Report").

[4] Proposing Release at 75783 n.92.

offerings of equity securities, and thus the Commission should narrow proposed Rule 106 to address only the abuses that prompted this rulemaking. In the absence of evidence that similar abuses have occurred in initial offerings of debt or secondary offerings of debt and equity securities, the Commission should, at a minimum, hesitate to impose the proposed Rule 106 restrictions to those offerings.[5]

We further believe that manipulative behavior in association with debt offerings or secondary offerings of equity securities is significantly less likely than in equity IPOs. The factors that provide the incentive to manipulate offerings are the scarcity of the security and the potential run-up in aftermarket price as a result of investor demand. In secondary offerings of equity securities, pricing is done in relation to an outstanding market, meaning that there is typically not a scarcity of the security being distributed and thus little or no opportunity for an aftermarket run-up. In fact, dilution often depresses, rather than increases, the aftermarket price of a secondary equity offering. Debt offerings are priced based on the creditworthiness of the issuer and will trade in the aftermarket at a price that is similar to other debt instruments with the same terms of issue and rating. With a significantly lower prospect of an aftermarket run-up, the motivation for manipulative behavior in connection with these offerings is absent.

If the Commission decides to apply proposed Rule 106 to all offerings, consideration also needs to be given to the interplay between Rule 106 and existing Rules 101 and 102. For example, in a secondary equity offering of an actively-traded security or in an offering of investment grade debt, the underwriter can engage in full-fledged market making during such offerings without violating Rule 101, pursuant to express exceptions to the general prohibitions of that rule. Given the broad language of proposed Rule 106, however, it would appear that such permissible activity might be rendered impermissible, or at least questionable, under Rule 106. This potential inconsistency would need to be addressed. By limiting proposed Rule 106 to equity IPOs, any such inconsistency between Rules 101 and 102 on the one hand and proposed Rule 106 on the other hand would be eliminated.

The NYSE and NASD ("the SROs") have proposed new rules that would prohibit certain abuses in the allocation and distribution of shares in IPOs, including arrangements where underwriters allocate IPO shares in exchange for excessive compensation from customers.[6] It is

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[5] There would appear to be no significant detriment to waiting to apply the proposed rule to such offerings in light of the Commission's view that the conduct reached by the proposed rule already is prohibited under section 17(a) of the Securities Act and section 10(b) and Rule 10b-5 of the Exchange Act, as well as by SRO rules. *See* Proposing Release at 75783 ("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 . . . [and] some forms of tie-ins are already prohibited by Regulation M and SRO rules.").

[6] *See* Securities Exchange Act Release No. 50896 (Dec. 20, 2004), 69 Fed. Reg. 77804 (Dec. 28, 2004) (the "SRO Proposing Release")

clear that the SROs intend their rule proposals to apply only to equity IPOs.[7] We suggest that the Commission adopt the NYSE definition of IPO to cover only equity securities,[8] because the abuses that were present in the late 1990's involved equity IPOs.

Finally, we recommend that the Commission consider applying proposed Rule 106 only to broker-dealers, as the impetus for the rule was abuses by broker-dealers in connection with IPOs.[9] We recognize that issuers and their affiliates could in some circumstances collude with an underwriter to induce purchasers into a tying or *quid pro quo* arrangement. As a practical matter, however, it is the underwriter that has the most incentive and opportunity to propose a tying arrangement, because it has a flow of offerings to distribute and ongoing relationships with purchasers.

Comments Regarding Covered Conduct

We also recommend that the Commission use Regulation M only to reach situations where customers of an underwriter agree to buy additional shares of the subject security or another security in the aftermarket as a condition to being allocated shares in a distribution.[10] Such "tying" arrangements traditionally have been the type of behavior dealt with under the auspices of Regulation M. As noted in the Proposing Release, "[t]he 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)

[7] *See* NYSE Rule 472.100 ("'initial public offering' refers to the initial registered equity security offering by an issuer").

[8] *See* ABA Section on Business Law Comment Letter on Securities Exchange Act Release No. 50896. As in that letter, however, we suggest that the Commission consider clarifying the definition of an IPO to exclude offerings of types of equity securities that are not subject to the same potential for aftermarket abuses that are associated with corporate IPOs because such offerings historically have traded in the aftermarket at a discount to the IPO price. For example, we believe that the term "IPO" should not include offerings by limited partnerships, limited liability companies, real estate investment trusts, any other offering structured as a "direct participation program," or closed end funds. Moreover, the term "IPO" should not include offerings of trust preferred, preferred, or convertible preferred securities.

[9] *See* Proposing Release at 75783; *see also* Proposing Release at 75775 (acknowledging that the amendments were being proposed "on the basis of" misconduct in connection with IPO offerings, as evidenced by "recent Commission and SRO actions and private litigation").

[10] The described arrangement is the classic "tie-in" agreement. *See* SEC Staff Legal Bulletin No. 10 (Aug. 2000).

of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act. In addition, some forms of tie-ins are already prohibited by Regulation M and SRO rules."[11]

With proposed Rule 106, however, the Commission attempts to bring within Regulation M a type of conduct distinct from tying arrangements. *Quid pro quo* arrangements involve situations where broker-dealers allocate shares based on a potential investor's agreement to pay excessive commissions on trades of unrelated securities or based on the investor's agreement to "kick back" to the broker-dealer a portion of the profits anticipated by the investor.[12] We believe that *quid pro quo* arrangements will be appropriately regulated under the rules proposed by the SROs, thus the Commission need not also establish rules regarding *quid pro quo* arrangements at this time.[13]

If the Commission nevertheless pursues a rule on *quid pro quo* arrangements, we suggest that it: (1) deal with such arrangements in a separate rule from proposed Rule 106, so as not to confuse such behavior with tying arrangements, and (2) use language similar to that proposed by the SROs in their proposed rules. In contrast to the standard set forth in proposed Rule 106, the proposed NYSE and NASD rules addressing *quid pro quo* arrangements would provide that "No member . . . may offer or threaten to withhold shares it allocates in an initial public offering as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the member."[14] We believe that the language in the proposed NYSE and NASD rules is clearer than the Commission's language in identifying the conduct that is prohibited and therefore would provide more certainty than the language of proposed Rule 106.[15]

The remainder of our discussion addresses only proposed Rule 106's applicability to tying arrangements.

<u>Comments Regarding Application of the Proposed Rule</u>

We are concerned that as applied to tying arrangements, the language of proposed Rule 106 could lead to inconsistent or inequitable enforcement. We believe that the standard set forth

[11] Proposing Release at 75783; *see also* SEC Staff Legal Bulletin No. 10 (Aug. 2000).

[12] *See* SRO Proposing Release; *see also* IPO Advisory Committee Report at 12.

[13] In a separate comment letter, we have expressed support for the proposal by the SROs to prohibit *quid pro quo* arrangements. We have, however, suggested several clarifications to the proposed language of the SRO rules.

[14] *See* SRO Proposing Release at 77804.

[15] As noted above in note 13, however, we have recommended a few clarifications to the proposed SRO rule language.

in the proposal—"attempted to induce" or "solicited" additional consideration in connection with an allocation of an offered security—introduces a degree of uncertainty that is unwarranted for a prophylactic rule. We recommend that the Commission consider alternative language for proposed Rule 106: "It shall be unlawful for a distribution participant in an IPO to require a potential purchaser, as a condition of receiving an allocation of IPO securities, to make additional purchase(s) of the offered security after trading in the security begins or of a security in an unrelated offering." We believe this language, which is similar to that considered for Rule 10b-20,[16] would reach most of the concerns that the Commission is seeking to address with the "attempt to induce" or "solicit" language. For instance, a broker-dealer would run afoul of such a rule, even where no purchase is made in the aftermarket, if it conditioned an allocation on the investor purchasing the securities in the aftermarket or purchasing securities in another offering. A violation would be based not upon any "solicitation," but on the broker-dealer's coercive conduct in acting to condition the allocation on the investor's agreement.

Although we commend the Commission for being sensitive to not disturbing allocations based on legitimate customer relationships, we also are concerned that the "attempt to induce" and "solicitation" language in proposed Rule 106 could impede efforts to assess possible aftermarket interest. As noted in the Report of the IPO Advisory Committee, the gathering of information about investors' long-term interest in and valuation of a particular issuer is essential to the book-building process.[17] An "attempt to induce" or "solicitation" should not be presumed solely from an underwriter's inquiry, nor should it be considered an "inducement" for purchase of more aftermarket shares when an underwriter partially fills an institutional investor's indication of interest for a large block of securities in order to spread the allocations among many institutions. These inquiries serve a legitimate purpose so long as there is no implicit or explicit agreement, promise, obligation, or commitment by the investor to buy in the aftermarket in order to obtain an allocation of securities.[18] It, therefore, will be important for the Commission, in interpreting and enforcing Rule 106, to distinguish between such legitimate actions on the one hand and intentional and explicit aftermarket tie-ins on the other.

Proposed Modification of Restricted Period for IPOs

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[16] *See* Securities Exchange Act Release No. 11328 (Apr. 2, 1975), 40 Fed. Reg. 16090 (Apr. 9, 1975). We recognize that as proposed, Rule 10b-20 would have covered both tying and *quid pro quo* arrangements. Consistent with the recommendations above, however, we believe that Rule 106 should be limited to tying arrangements.

[17] IPO Advisory Committee Report at 6.

[18] *See, e.g.,* SEC v. J.P. Morgan Securities Inc., No. 03 Civ. 02028 (D. D.C. 2003), Complaint (noting that JP Morgan described certain customers' aftermarket interest as promises, obligations, or commitments to buy stock in the aftermarket and that it "implicitly conveyed to certain customers that providing aftermarket interest and aftermarket buying was important").

The Commission proposes to establish a restricted period especially for IPOs. The proposed amendment is prompted by concerns that there is no independent pricing mechanism by which a prospective investor can evaluate the IPO price set by underwriters and, as a result, any inducement activity by underwriters or other distribution participants can have long-lasting effects. Therefore, the proposed amendment would establish a significantly longer restricted period specifically for first-time offerings. In particular, the proposed IPO restricted period would begin at the earlier of: (1) when the issuer reaches an understanding with an underwriter to proceed with a distribution, or (2) if there is no underwriter, 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. The restricted period would conclude when the distribution is completed.

We urge the Commission to establish a more objective trigger date for the new IPO restricted period. We suggest two alternatives to the proposed start date for the restricted period: the date the registration statement is filed with the SEC, or the date the red herring prospectus is circulated. Both of these options would have the benefit of giving broker-dealers a date certain on which the restricted period rules apply, whereas the proposed rule standard based on when an understanding is reached with an underwriter relies on a measure that is open to interpretation.

We also note that in connection with the proposed amendment to the restricted period for IPOs, the SEC proposes to establish a definition of IPO for purposes of the rule. The proposal would define IPO in Rule 100(b) to mean: (1) an issuer's first offering of a security to the public in the United States, and (2) 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 US. The Commission proposes "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."[19] As with proposed Rule 106, we believe that the proposed definition is too broad because it covers types of offerings in which no abuses have been identified. The issues prompting the SEC to consider revising the rule arose in equity offerings. Therefore, we suggest that the Commission limit the definition of an IPO for purposes of the restricted period rule to include only equity offerings.[20]

Syndicate Covering Bids

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[19] Proposing Release at 75777.

[20] We have noted in a prior section, as well as in a separate comment letter on the SRO Proposals, that we endorse (with a few clarifications) the NYSE definition of an IPO. *See* NYSE Rule 472.100.

Rule 104(h)(2) provides 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." The Commission proposes to amend Rule 104(h)(2) to "require a managing underwriter or other person communicating a bid that is for the purpose of effecting a syndicate covering transaction to identify or designate the bid as such wherever it is communicated." Such covering bids would be identified to the SRO with direct authority over the principal market in the United States for the security.

We are concerned that the Commission's proposal to require a designation on individual covering bids may pose logistical and/or functional problems. Unlike symbols for stabilizing bids and passive market making bids, which are implemented the night before they are used, the proposed rule would require the managing underwriter to request a bid designation, intra-day and potentially numerous times a day on a periodic basis, to effect a syndicate covering transaction. Based on our preliminary conversations with The Nasdaq Stock Market, Inc., we understand that in order for Nasdaq to accept such a designation, the broker-dealer's quotes would need to be taken out of the market for a time period that could be as short as thirty seconds or as long as 2 minutes. We are concerned that this could be highly disruptive to the market.

We nevertheless believe that the market should be informed of syndicate covering activity, because such information contributes to market efficiency. We therefore suggest an alternate form of notification. We recommend that the Commission require book-running lead managers to attach a symbol to their bids in the market until all syndicate short covering activity, effected either through exercises of the "green shoe" or syndicate covering in the market, is complete. Such a rule would be much more reasonable to comply with than a transaction-by-transaction notification, yet still would serve to inform the market of the possibility that the market price is being supported by syndicate activity.

Penalty Bids

With respect to the Commission's proposal to prohibit penalty bids, we understand from industry participants that such bids are still used, especially in the context of offerings of closed-end funds. Therefore, we suggest that the Commission hesitate to prohibit all penalty bids. We would support, however, efforts to eliminate the inequitable imposition of penalty bids.[21]

Modified Dollar Amount Thresholds

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[21] As noted by the Commission, there is evidence that institutional salespersons are not penalized when their institutional customers flip their shares, but retail salespersons often are penalized. Proposing Release at 75782.

We endorse the proposed amendments to Rules 100(b), 101(b)(7) and (c)(1), and 102(d)(1) that would update the dollar amount thresholds used to determine a security's restricted period and the availability of the exception for actively-traded securities to reflect inflation. We urge the Commission also to consider updating the dollar amount thresholds in Exchange Act Rule 10b-18, which are derived from Regulation M. When the Commission adopted amended Rule 10b-18(b)(2)(ii), it reasoned that there should be an allowance for securities that are more liquid and thus less susceptible to manipulation to stay in the market longer. Accordingly, the Commission adopted a timing amendment that incorporated Regulation M's standards and methods of calculating ADTV and public float value.[22] Because Rule 10b-18(b)(2)(ii) mirrors certain of the specific standards set forth in Regulation M, amendments to the Regulation M dollar amounts should be echoed in an amendment to Rule 10b-18(b)(2)(ii).[23]

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The Committee appreciates the opportunity to comment on the proposal and respectfully requests that the Commission consider the recommendations set forth above. We are prepared to meet and discuss these matters with the Commission and the staff and to respond to any questions.

Respectfully Submitted,

Committee on Federal Regulation of Securities

/s/ Dixie L. Johnson
Committee Chair

Drafting Committee:

Brandon Becker
Andre Owens
Suzanne Rothwell
Barbara Endres

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[22] Securities Act Release No. 8335, Securities Exchange Act Release No. 48766, Investment Company Act Release No. 26252 (Nov. 10, 2003), 68 Fed. Reg. 64952, 64957 n. 53 (Nov. 17, 2003).

[23] Should the Commission act to update Rule 10b-18 in accordance with this update of Regulation M's dollar amount thresholds, we recommend that it also consider cross-referencing the Regulation M standards. In doing so, the Commission would ensure that any further updates to Regulation M would automatically affect Rule 10b-18, without any additional action.

Susan Grafton
Jerome Roche
Jaime Klima
Stuart Nayman
Cathy Dixon