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February 15, 2005

Via E-mail (rule-comments@sec.gov)

Jonathan G. Katz, Secretary,
Securities and Exchange Commission,
450 Fifth Street, N.W.,
Washington, D.C. 20549-0609.

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

Dear Mr. Katz:

We are pleased to submit this letter in response to the Commission's request for comments on its proposals to amend Regulation M (the "Proposals") as contained in Release No. 34-50831 (Dec. 9, 2004) (the "Release").

We have set forth below our comments on a few specific aspects of the Proposals that we believe can be improved or clarified in a manner consistent with the purpose of the Proposals. We have not commented on some of the significant policy questions raised by the Proposals, including whether disclosure of syndicate short-covering bids should be required and whether penalty bids should be prohibited.¹

Restricted Period

Exception to allow IPO-related restructurings and recapitalizations. In connection with a distribution of securities, Rules 101 and 102 of Regulation M establish a restricted period during which covered persons must refrain from bidding for or purchasing, or attempting to induce others to bid for or purchase, the securities being distributed and any

¹ We note, however, that many of the studies cited by the Commission in the Release to support its proposals to require disclosure of syndicate short-covering bids are not recent, and we question whether the costs and benefits of the proposed new rule should be re-evaluated prior to adoption.

reference security, unless one of several specified exceptions applies. Under current rules, the restricted period begins five business days before the day of the pricing in connection with IPOs, and generally continues as to each covered person until that person's participation in the distribution is completed.

The Proposals would amend the definition of "restricted period" with respect to IPOs² so that the period begins much earlier in the offering process, at the earlier of (1) the time when the issuer reaches an understanding with a broker-dealer that is to act as an underwriter and (2) the time the registration statement is filed with the SEC or other offering document is first circulated to potential investors.

In our experience, it is not uncommon in connection with an IPO for the issuer to "clean up" or strengthen its capital structure prior to the offering by means of a recapitalization or other transaction. Pre-IPO transactions of this nature might involve, for example, the issuer issuing a new class of common stock in exchange for other classes of its outstanding securities, repurchasing outstanding common stock or simply placing common stock privately with strategic investors. These activities may involve purchases of covered securities, or inducements to purchase covered securities, by the issuer, selling security holders or their affiliated purchasers.

In many cases today, these arrangements are entered into before the five-day restricted period starts. As a result, even if these transactions settle later, they would not be prohibited under Rule 102. By starting the IPO restricted period as early as the Commission proposes, however, Rule 102 may prevent these legitimate – and indeed, necessary – IPO-related transactions. We respectfully suggest that the Commission address this issue in two ways.

First, we believe that a sale of securities of the same class as the distribution securities by the issuer, a selling security holder or an affiliated purchaser, made outside the distribution, should be excepted from the scope of Rule 102, and we urge the Commission to confirm this view. One way to do so would be to amend the language of Rule 102(b)(5) to conform to the language of Rule 101(b)(9). Both of these rules except offers to sell (and solicitation of offers to buy) the securities being distributed, but Rule 101(b)(9), unlike Rule 102(b)(5), also excepts "securities offered as principal by the person making such offer or solicitation." It would be helpful if Rule 102(b)(5) also contained this additional language. This modification should not be limited to the pre-IPO period, as issuers, selling security holders and affiliated purchasers should be permitted to sell securities as principal outside the distribution in other situations, including follow-on offerings and post-pricing. Because these "inducements" involve securities being offered as principal, they should not have the impact

² The Proposals would define "IPO" to mean an issuer's first offering of a security to the public in the United States and, if prior to the first offering the issuer's equity securities do not have a public float value, "IPO" would mean the issuer's first offering of an *equity* security to the public in the United States.

on the market for distribution securities that inducements to purchase the securities from other sources (*e.g.*, in the open market) could have.

Our proposed change would merely conform the language of the exception for offers to sell as it appears in Rule 102 to the comparable exception in Rule 101. In our experience, the Commission's rationale for providing a narrower set of exceptions from Rule 102 than from Rule 101 – in this case, that issuers, selling security holders and their affiliated purchasers, unlike underwriters and their affiliated purchasers, do not have legitimate reasons to make offers to sell as principal outside the distribution³ – has proven not to be true with regard to principal sales. The difference in the wording of comparable exceptions under Rule 101(b)(9) and Rule 102(b)(5) has proven to be a potential obstacle to legitimate transactions with no market impact and a trap for the unwary, since offers to sell as principal outside the distribution would normally appear to raise no concerns of the kind Regulation M is designed to address and thus could easily be overlooked as potentially prohibited by Rule 102. We note also that there was no such distinction in the application of this exception during the many years when Rule 10b-6, the predecessor to Rules 101 and 102, was in effect.

Second, to address the issue of pre-IPO purchases, the Commission should add a new exception under Rule 102(b) for privately negotiated transactions not taking place on a securities exchange, through an inter-dealer quotation system or on an electronic communications network, provided that the transactions are entered into (although not necessarily settled) prior to the pricing of the offering. According to the Release, the Commission proposes to start the restricted period in IPOs earlier because there is no trading market to provide an independent pricing mechanism for investors to evaluate the IPO price and, therefore, any inducement activity by underwriters and other distribution participants can have long-lasting effects.⁴ We believe that privately negotiated transactions effected by issuers and other covered persons in connection with pre-IPO recapitalizations would not raise these concerns.

If the Commission believes that these transactions potentially could have an impact on the market for the securities in distribution in the non-IPO context, or in an IPO aftermarket, the exception could be limited to transactions prior to the pricing of an IPO. We see little reason for concern that private, pre-IPO transactions could affect the aftermarket. We also view this proposed exception as a logical and useful extension of the existing

³ Another reason cited in the 1996 Regulation M proposing release for providing fewer exceptions from Rule 102 than from Rule 101 – that Rule 102 participants have a greater stake in the offering and, presumably, a greater incentive to manipulate – is simply not relevant in the context of offers to *sell* as principal. *See* Proposed Rule: Trading Practices Rules Concerning Securities Offerings, Rel. No. 34-37094 (Apr. 11, 1996), at part III.C.3.a. Concern about a lack of market surveillance is also misplaced in this context, as these transactions typically are disclosed in the offering prospectus.

⁴ *See* Release at second paragraph following paragraph referencing note 27.

exception for transactions among distribution participants in Rule 102(b)(8), which may cover some but not all the legitimate and necessary pre-IPO transactions that could now be prohibited by the earlier start of the IPO restricted period.

Clarify that pre-filed materials are not “disseminated” to security holders.

The Proposals would provide that, in the context of a merger, acquisition or exchange offer, the restricted period would begin when “proxy solicitation or offering materials are first disseminated to security holders.” Exchange Act Rules 14a-12(b) and 14d-2(b)(2) and Securities Act Rule 425(b) allow solicitation and offering materials to be filed with the Commission prior to the time that the materials are first published, sent or given to security holders. We respectfully suggest that the Commission clarify in the adopting release that these pre-use filings do not constitute “dissemination” of proxy or offering materials and do not trigger the restricted period in this context.

Regulation of Allocation Practices

Proposed new Rule 106 would make it unlawful for covered parties to “attempt to induce, induce, solicit, require, or accept” from a potential purchaser of an offered security, in connection with an allocation of those securities, “any consideration for such offered security in addition to that stated in the registration statement” or other offering document.

The Release indicates that the proposed rule is designed to prohibit certain allocation practices that occurred in connection with IPOs in the late 1990s and other “hot issue” periods, such as “tying” or conditioning an allocation of shares in a hot issue on an understanding that the customer would buy shares in another, usually “cold issue” or would pay excessive commissions to the underwriter in other trades. However, the language of proposed Rule 106 is not limited to the offending practices identified by the Commission in the Release. Proposed Rule 106 is not even limited to IPOs or registered public offerings but would apply to any “distribution” of securities, including private placements and follow-on offerings.

We respectfully urge the Commission to reconsider the proposed rule. Any new rule should be focused more precisely on the objectionable practices cited in the Release. We note that the SROs have recently proposed rules that prohibit members from offering or threatening to withhold shares allocated in an IPO as consideration or inducement for the receipt of “excessive” compensation in relation to the services provided by the member, instead of prohibiting all efforts to obtain “additional” consideration, as proposed Rule 106 would.⁵ The Release states that the proposed rule is not intended to interfere with “legitimate” customer relationships and would not, for example, prohibit a firm from

⁵ See Self-Regulatory Organizations; Notice of Filing of Proposed Rule Changes by the New York Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in Initial Public Offerings (“IPOs”), Rel. No. 34-50896 (Dec. 20, 2004). The SRO proposals would also specifically address “spinning,” “flipping” and other IPO pricing and trading practices.

allocating IPO shares to a customer because the customer has separately retained the firm for other services, as long as the customer has not paid excessive compensation for those services. However, the broad language of the proposed rule could be read to prohibit just such “legitimate” customer relationships by prohibiting efforts to seek any *additional* compensation, whether or not excessive and whether or not limited to legitimate, separate transactions. We believe that the “excessive compensation” standard of the SRO rules better ensures that the proposed rule would not interfere with legitimate customer relationships and that legitimate allocations of IPO shares to clients or potential clients could continue. We urge the Commission not to adopt proposed Rule 106 unless it incorporates the “excessive consideration” standard from the SRO proposals.

Moreover, in order to avoid duplicative and potentially inconsistent regulation, it would be preferable for the Commission to withdraw proposed Rule 106 and to rely on the SROs to address the allocation issue through their currently proposed rules. Given the prior statements by the staff of the Commission about the application of Rule 101 to inducements of aftermarket purchases, we believe there is no need to expand Regulation M with regard to allocation practices. To the extent that they involve something other than inducements to buy in the aftermarket, allocation practices are more properly regulated by the SROs, which traditionally have taken the lead in regulating potentially unjust or inequitable business practices of broker-dealers.

Disclosure of Syndicate Covering Bids

Under current rules, any person displaying or transmitting a known stabilizing bid must provide prior notice to the market where the bid will be made and disclose the purpose to the person to whom the bid is submitted.⁶ The Proposals would add a new requirement that any person communicating a bid for the purpose of effecting a syndicate covering transaction must identify or designate the bid as such, wherever it is communicated.

The proposed disclosure rule, however, does not specify how syndicate covering bids are to be designated or identified. The Release instead states that the proposed rule is intended to require identification of these bids analogous to the identification of stabilizing bids required under current rules, and places the burden of satisfying the proposed rule on the underwriter or other person displaying or transmitting a syndicate covering bid. While the Release indicates that the Commission expects the SROs to develop procedures that would provide wide notice of such bids to the markets, for example, with a special identifying symbol, we believe that the effectiveness of any final rule in this regard should be delayed until a means for compliance with the new disclosure requirements is prescribed by the SROs.

⁶ The SROs have adopted procedures that enable underwriters to satisfy this disclosure requirement. The NASD requires market makers intending to initiate stabilizing bids in an offering of a Nasdaq security to provide it with prior notice, and the stabilizing bids are then identified by a symbol on the Nasdaq quotation display. *See* NASD Rule 4614. For stabilizing bids on the NYSE, underwriters must notify the exchange and provide disclosure to the specialist to whom the bid is submitted. *See* NYSE Rule 392.

We believe that broader disclosure – such as requiring the managing underwriter to notify the market, through a press release or a website posting, that syndicate covering has begun or ended or that the underwriting syndicate has an uncovered short position in the offered security and the size of the position – is not necessary to satisfy the Commission’s basic goal that syndicate covering transactions avoid a “false or misleading appearance in the trading market for the offered security.”⁷ Indeed, disclosure of certain matters, such as disclosure of the actual size of a short position, could put the syndicate at a competitive disadvantage relative to other market participants.

Definition of Valuation Period

We respectfully suggest that the proposed definition of “valuation period” clearly exclude any period in which the market price of the offered security is being used solely to calculate the amount of cash payable in the transaction in lieu of a fractional share.

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We appreciate the opportunity to comment on the Proposals, and would be pleased to discuss any questions that the Commission may have with respect to this letter. Any such questions may be directed to John T. Bostelman (212-558-3840) or David B. Harms (212-558-3882) in our New York office or to Eric J. Kadel, Jr. (202-956-7640) in our Washington, D.C. office.

Very truly yours,

SULLIVAN & CROMWELL LLP

cc: Annette L. Nazareth, Director, Division of Market Regulation
James Brigagliano, Assistant Director, Division of Market Regulation

⁷ See Release at paragraph referencing note 78.

