SEC Issues Guidance on Regulation M and IPO Allocations

The Securities and Exchange Commission (the “SEC”) has issued interpretive guidance reminding underwriters, broker-dealers and other persons participating in securities distributions that attempting to induce aftermarket bids or purchases until the completion of the distribution violates Regulation M. The guidance specifies seven activities prohibited in connection with initial public offering (“IPO”) allocations and comes on the heels of two recent SEC enforcement cases alleging violations of Regulation M in the IPO offering process.1 See Release No. 33-8565 (April 7, 2005), at http://www.sec.gov/rules/interp33-8565.pdf. While the guidance is effective immediately, the SEC will accept comments through June 7, 2005.

Background

As an anti-manipulation regulation, Regulation M is intended to protect the integrity of the offering process by precluding activities that could artificially influence the market for offered securities. Regulation M “prohibits distribution participants from ‘directly or indirectly . . . attempt[ing] to induce any person to bid for or purchase’ any security that is the subject of a distribution otherwise than in the distribution.”2 Thus, solicitations, “tie-in” agreements and other attempts to induce aftermarket bids or purchases—characteristic, in the SEC’s view, of “hot” equity markets—are prohibited until the distribution is completed.

The SEC states that Regulation M applies to “attempts,” thus proscribing a distribution participant’s conduct regardless of whether it actually results in market activity by others. In addition, the prohibitions of Regulation M apply to such conduct regardless of the intent of the distribution participant. As the release states, “no proof of scienter is required.”

The SEC views attempts to induce aftermarket bids or purchases during a distribution as “undermining the integrity of the market as an independent pricing mechanism for the securities offered by giving purchasers the impression that there is a scarcity of the offered securities,” stimulating demand, and eroding investor confidence in the capital raising process.

The SEC has recently proposed a number of amendments to Regulation M relating in large part to practices of underwriters in the IPO process. The amendments seek to, among other things, lengthen the restricted period for IPOs, require disclosure of syndicate covering bids, eliminate penalty bids, and prohibit the acceptance of additional consideration in exchange for an allocation of securities.3

“Hot” IPOs

In the context of an IPO, Regulation M’s prohibition on attempts to induce bids and purchases focuses on impermissible conduct during the restricted period that could stimulate others to engage in transactions in the aftermarket. In hot IPO markets, underwriters may link investor willingness to engage in immediate aftermarket purchases with an allocation of the IPO shares. According to the SEC’s interpretive guidance, this violates Regulation M and also may violate the general antifraud and anti-manipulation provisions of the securities laws.

The NYSE/NASD IPO Advisory Committee issued a report in May 2003,4 which found that “allocating IPO shares based on a potential investor’s commitment to purchase additional shares in the aftermarket at specified prices” (known as “laddering”) was among the most harmful of the practices that artificially

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inflated aftermarket prices during the “IPO bubble” of the late 1990s and 2000. In response to the NYSE/NASD IPO Advisory Committee, the NASD has substantially modified its proposed Conduct Rule 2712 relating to IPO allocations and distributions.5

**Book-Building Activities**

The SEC recognizes the importance of the book-building process in obtaining and assessing investor demand for an offering and in pricing the securities, but reminds market participants that “there is no ‘book-building exception’ to Regulation M for inducing or attempting to induce aftermarket bids or purchases.” While obtaining and assessing information about demand for an offering during the book-building process would not, by itself, constitute an inducement or an attempt to induce aftermarket purchases, ancillary conduct or communications, including undertaking any of the seven prohibited activities described below, could cause this aspect of the book-building process to violate Regulation M.

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. The release provides guidance for compliance with Regulation M with respect to the book-building process.

**Focus on Seven Prohibited Activities**

The SEC states that the release is a “reminder” that certain conduct that causes or is likely to cause an undertaking, a promise, a commitment, or an understanding on the part of a customer to make aftermarket bids or purchases, in relation to an expected allocation of IPO shares, is not permitted under Regulation M.

The release highlights seven prohibited activities that the SEC believes tend to create offering demand, cause artificial aftermarket price escalation, and erode market integrity. The release states:

When offerings are sold based upon an artificially manufactured perception of scarcity and priced on stimulated buying pressure, IPO investors are unable to evaluate the offering to determine that it has been appropriately priced. Moreover, other investors who bid for or purchase shares in the aftermarket would not know that the aftermarket demand had been stimulated by the underwriters’ unlawful conduct.

The release advises that underwriters avoid the following activities during restricted periods:

1. **Inducements to purchase in the form of tie-in agreements or other solicitations of aftermarket bids or purchases prior to the completion of the distribution.**

2. **Communicating to customers that expressing an interest in buying shares in the immediate aftermarket (or immediate aftermarket buying) would help them obtain IPO allocations.**

3. **Soliciting customers prior to the completion of the distribution regarding whether and at what price and in what quantity they intend to place immediate aftermarket orders for IPO shares.** However, the release states that inquiring as to customers’ desired future positions in the longer term (for example, three to six months) and the price at which customers might accumulate those positions, without reference to immediate aftermarket activity, would not itself be a violation.

4. **Proposing aftermarket prices to customers or encouraging customers who indicate interest in the aftermarket to increase the prices at which they are willing to place orders in the immediate aftermarket, which creates the impression of a strong offering demand and a scarcity of shares.**

Communicating to customers information obtained from third parties regarding their valuation of an issuer or the offering price would be permitted if the conduct is not likely to cause the customer to express an interest in paying a higher price in the immediate aftermarket. However, the release states that encouraging an increase in prices, including by communicating prices of aftermarket interest of third parties, would be viewed as improperly conveying to a customer that a commitment in the aftermarket at higher price levels is expected.

5. **Accepting or seeking expressions of interest from customers that they intend to purchase an amount of shares in the aftermarket equal to the size of their IPO allocation (“one-for-one”) or intend to bid for or purchase specific amounts of shares in the aftermarket that are pegged to the allocation amount without any reference to a fixed total position size.** Where, without prompting from the salesperson, a customer expresses a desire to purchase in the aftermarket, there may be no “attempt to induce” by the salesperson. However, the release clarifies that a prior course of dealing between the firm and the investor involving communications by the firm that the investor is expected to provide this type of aftermarket price and quantity information would suggest that the aftermarket purchase may

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have been induced by the firm despite the seeming spontaneity of the customer’s expression of interest. Whether or not the customer’s statement is unprompted, an acceptance of a customer’s offer to purchase shares in the immediate aftermarket that is “expressly linked to the receipt of an allocation” is a prohibited tie-in agreement in violation of Regulation M.

6. Soliciting aftermarket orders from customers before all IPO shares are distributed or rewarding customers for aftermarket orders by allocating to them additional IPO shares. By rewarding customers who place orders in the immediate aftermarket with additional IPO shares in the same offering, the underwriter would be viewed as improperly stimulating aftermarket purchases during the restricted period.

7. Communicating to customers, in connection with one offering, that expressing an interest in the aftermarket or buying in the aftermarket would help them obtain IPO allocations of stock in other IPOs. In this case, the broker would be inducing or attempting to induce aftermarket bids or purchases by linking an expectation of aftermarket bids or purchases to the customer’s desire to receive allocations in future IPOs. By contrast, the guidance provides that determining that a customer may be a long-term investor in a particular security, and any related communications with that customer, would not, in and of themselves, violate Regulation M.

The SEC emphasizes that, because the mix of facts and circumstances of a particular communication or activity will determine whether there is a Regulation M violation, these seven activities do not represent an exhaustive list of the types of conduct that violate Regulation M.

Policies and Procedures

The release advises that firms establish effective policies and procedures to detect and prevent prohibited solicitations, tie-in agreements, and other attempts to induce aftermarket bids or purchases during the Regulation M restricted period. Firms should implement policies prohibiting these activities, ensure that firm employees are reasonably supervised with a view to preventing such conduct, and take corrective action if any breaches occur. The release also suggests that firms “monitor” such activities, but does not suggest how best to do so.
This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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