SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 231, 241, and 271

[Release Nos. 33–8565; 34–51500; IC–26828; File No. S7–03–05]

Commission Guidance Regarding Prohibited Conduct in Connection with IPO Allocations

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation; solicitation of comments.

SUMMARY: The Securities and Exchange Commission (Commission) is publishing this interpretive release with respect to prohibited conduct in connection with securities distributions, particularly with a focus on initial public offering (IPO) allocations. The Commission is soliciting comment on the issues discussed here.

DATES: *Effective Date:* April 7, 2005.

Comment Due Date: Comments should be received on or before June 7, 2005.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/interp.shtml*); or
- Send an e-mail to *rule-comments@sec.gov*. Please include File Number S7–03–05 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. All submissions should refer to File Number S7–03–05. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/interp.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Any of the following attorneys in the Office of Trading Practices, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001, at (202) 942–0772: James Brigagliano, Assistant Director; Joan Collopy, Special Counsel; Elizabeth Sandoe, Special Counsel; Liza Orr, Special Counsel; or Elizabeth Marino, Attorney.

Executive Summary: The purpose of this release is to provide guidance under Regulation M with respect to the process known as book-building, including the process for allocating shares in initial public offerings (''IPOs''). The Commission recently brought three enforcement cases alleging abuses in the offering process in contravention of Regulation M. Based on these cases, the Commission seeks to highlight certain prohibited activities that underwriters should avoid during restricted periods. These include:

- 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.
- Communicating to customers that expressing an interest in buying shares in the immediate aftermarket (''aftermarket interest'') or immediate aftermarket buying would help them obtain allocations of hot IPOs.
- 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 stock.
- Proposing aftermarket prices to customers or encouraging customers who provide aftermarket interest to increase the prices that they are willing to place orders in the immediate aftermarket.
- 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 (''1 for 1'') 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.
- Soliciting aftermarket orders from customers before all IPO shares are distributed or rewarding customers for aftermarket orders by allocating additional IPO shares to such customers.
- 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 other hot IPOs.

SUPPLEMENTARY INFORMATION:

I. Introduction

Solicitations or other attempts to induce aftermarket bids or purchases during a distribution undermine the integrity of the market as an independent pricing mechanism for the offered securities by giving purchasers the impression that there is a scarcity of the offered securities. This improper conduct by underwriters of IPOs erodes investor confidence in the capital raising process. In recognition of the serious adverse impact of these activities, the Commission has adopted rules, most recently embodied in Regulation M, which prohibit these activities as a prophylactic matter.[1]

Attempts to induce aftermarket bids or purchases during a Regulation M restricted period, or a cooling-off period as it was known under its predecessor, Rule 10b-6, have always been prohibited under these rules.[2] We first provided guidance under Rule 10b-6 concerning abusive practices in connection with IPO allocations in 1961.[3] In 2000, the Division of Market Regulation staff reminded underwriters that restricted period solicitations and tie-in agreements for aftermarket purchases are prohibited conduct under Regulation M.[4] Recent enforcement actions suggest that during the hot IPO market of the late 1990s and 2000, some underwriters and other market participants failed to comply with Regulation M or previous guidance.[5] As

[1] Regulation M (17 CFR 242.100–105) generally prohibits inducements of any transactions other than those necessary to conduct the offering. In the context of IPOs, the prohibition is generally discussed in terms of the ''aftermarket,'' *i.e.*, trading after the distribution period is over. Regulation M is the successor to former Rules 10b–6, 10b–6A, 10b–7, 10b–8, and 10b–21, and includes the basic prohibitions of those rules. *See* Securities Exchange Act Release No. 38067 (December 20, 1996), 62 FR 520 (January 3, 1997) (Regulation M Adopting Release). Recently, the Commission published for comment proposed amendments to Regulation M. Securities Exchange Act Release No. 50831 (December 9, 2004), 69 FR 75774 (December 17, 2004) (Regulation M Proposing Release). *See infra* notes 6 and 11.

[2] Regulation M defines the term restricted period in Rule 100(b) (17 CFR 242.100(b)). *See infra* note 11.

[3] Securities Exchange Act Release No. 6536 (April 24, 1961) (stating that practice of distribution participants of IPOs making ''allotments to their customers only if such customers agree to make comparable purchases in the open market after the issue is initially sold'' violated Rule 10b-6).

[4] Staff Legal Bulletin No. 10, ''Prohibited Solicitations and ''Tie-in'' Agreements for Aftermarket Purchases,'' August 25, 2000.

[5] *See SEC* v. *J.P. Morgan Securities, Inc.,* No. 1:03CV02028 (ESH) (Complaint) (October 1, 2003). *See also SEC* v. *Goldman Sachs Group, Inc.,* No. 05 SV 853 (SAS) (Complaint) (January 25, 2005); *SEC* v. *Morgan Stanley & Co., Inc.,* No. 1:05 CV 00166 (HHK) (Complaint) (January 25, 2005). In ''hot'' IPOs, investor demand significantly exceeds the supply of securities in the offering and the stock

a result, we find it appropriate to remind distribution participants and their affiliated purchasers that attempting to induce aftermarket bids or purchases during a restricted period violates Regulation M. Such guidance is necessary at this time to forestall improper conduct while continuing to promote legitimate underwriting practices that will facilitate capital formation.

II. Regulation M Prohibits Attempts To Induce Aftermarket Bids or Purchases

As a prophylactic rule, Regulation M precludes activities that could influence artificially the market for an offered security.[6] Specifically, Rule 101[7] makes it unlawful for any distribution participant[8] or its affiliated purchasers,[9] ''directly or indirectly, to bid for, purchase, or attempt to induce any person to bid for or purchase, a covered security'' [10] during the distribution's restricted period.[11] Like its predecessor, Rule 10b-6, Regulation M is intended ''to assure that distributions of securities are free of the market effects of bids, purchases, and inducements to purchase by those who have an interest in the success of a distribution.'' [12] Regulation M therefore addresses direct and indirect market activity by distribution participants and conduct by distribution participants ''that causes or is likely to cause another person to bid for or purchase covered securities.'' [13]

Attempts to induce bids or purchases of covered securities directed at aftermarket transactions fundamentally interfere with the independence of the market dynamics that are essential to the ability of investors to evaluate the terms on which securities are offered. Among other things, attempts to induce aftermarket bids or purchases can give prospective IPO purchasers the impression that there is a scarcity of the offered securities and the balance of their buying interest therefore can only be satisfied in the aftermarket.[14] As discussed below, attempts to induce aftermarket bids or purchases are prohibited throughout the restricted period.

First, Regulation M applies to ''attempts,'' thus proscribing a distribution participant's conduct irrespective of whether it actually results in market activity by others.[15] It is the inducement or the attempt to induce during the restricted period that Regulation M prohibits. The induced activity (*i.e.*, aftermarket bids or purchases) may occur during or after the restricted period, or indeed may never occur at all. Second, we have said that ''inducement to purchase'' broadly refers to ''activity that causes or is likely to cause another person to bid for or purchase covered securities.'' [16] The prophylactic prohibitions of Regulation M apply to such conduct regardless of intent of the distribution participant or affiliated purchaser. Therefore, no proof of scienter is necessary.[17] Whether

trades at a premium in the immediate aftermarket. See NYSE/NASD IPO Advisory Committee, Report and Recommendations (*http://www.nasdr/com/pdf-text/ipo_report.pdf*) (May 2003) (IPO Advisory Committee Report).

[6] *See* Regulation M Adopting Release, *supra* note 1. On October 13, 2004, the Commission proposed amendments that would extend the scope of Regulation M. Regulation M Proposing Release, 69 FR 75774. The guidance provided in this release, which addresses misconduct that currently violates Regulation M, is consistent with those proposed amendments.

[7] 17 CFR 242.101(a).

[8] *Distribution participants* include underwriters, prospective underwriters, brokers, dealers, or other persons who have agreed to participate or are participating in a distribution. 17 CFR 242.100(b).

[9] *Affiliated purchasers* include, among others, persons acting, directly or indirectly, in concert with distribution participants, issuers, or selling security holders in connection with the acquisition or distribution of any covered security. 17 CFR 242.100(b).

[10] A *covered security* is the security in distribution or any reference security. A *reference security* is any security into which the security in distribution may be converted. 17 CFR 242.100(b).

[11] 17 CFR 242.101(a). *Restricted period,* as defined in Rule 100(b) of Regulation M, means: ''(1) For any security with an ADTV value of $100,000 or more of an issuer whose common equity securities have a public float value of $25 million or more, the period beginning on the later of one business day prior to the determination of the offering price or such time that a person becomes a distribution participant, and ending upon such person's completion of participation in the distribution; and (2) For all other securities, the period beginning on the later of five business days prior to the determination of the offering price or such time that a person becomes a distribution participant, and ending upon such person's completion of participation in the distribution. (3) In the case of a distribution involving a merger, acquisition, or exchange offer, the period beginning on the day proxy solicitation or offering materials are first disseminated to security holders, and ending upon the completion of the distribution.'' 17 CFR 242.100(b). Among other things, the proposed amendments to Regulation M would lengthen the ''restricted period'' for IPOs beyond the current 5-day period, and update the ADTV and public float values in the definition of restricted period to reflect changes in the value of the dollar since Regulation M's adoption in 1996. The proposed amendments would also incorporate into Regulation M's restricted period definition the Commission's long-standing interpretation that valuation and election periods in connection with mergers, acquisitions, and exchange offers are included in a restricted period. Regulation M Proposing Release, 69 FR 75774.

[12] *See* Securities Exchange Act Release No. 21332 (September 19, 1984), 49 FR at 37572, Research Reports (September 25, 1984). Similarly, the Regulation M Adopting Release states that Regulation M is ''intended to preclude manipulative conduct by persons with an interest in the outcome of an offering.'' Regulation M Adopting Release, 62 FR at 520. The scope of the prohibition is so comprehensive that a specific exception is included in Regulation M to permit underwriters to solicit purchases of securities in the offering itself. 17 CFR 242.101(b)(9) (excepting from Rule 101(a) ''[o]ffers to sell or the solicitation of offers to buy the securities being distributed (including securities acquired in stabilizing), or securities offered as principal by the person making such offer or solicitation'').

[13] Securities Exchange Act Release No. 33924 (April 19, 1994), 59 FR 21681 at 21687 (April 26, 1994) (Regulation M Concept Release). *See* 17 CFR 242.101(a) and Regulation M Adopting Release, *supra* note 1. *See also Americorp Securities, Inc.,* Securities Exchange Act Release No. 41728 (August 11, 1999) (broker-dealer firm and CEO violated Rule 10b–6 by directing registered representatives to solicit and accept aftermarket purchase orders for an IPO from numerous retail customers before the effective date of the IPO). *See also SEC* v. *Wexler,* Securities Exchange Act Release No. 14489 (September 21, 1995); *P.N. MacIntyre & Co., Inc.,* Securities Exchange Act Release No. 10694 (March 20, 1974) (broker-dealer firm violated Rule 10b–6 by bidding for, purchasing or attempting to induce others to purchase securities in an offering underwritten by the broker-dealer firm before completion of the firm's participation in the distribution).

[14] *See* Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88–95, pt. 1 at 520–21, 556 (1 Sess. 1963) (Special Study). The Special Study found that ''[t]raders and customers both stated that prior to the effective date [of the registration statement] retail firms received buy orders or indications of interest from customers to purchase new issues at premium prices in the after-market and that these orders were then transmitted to trading firms for execution in the after-market.'' The Special Study then notes: ''[I]f broker-dealers are prospective underwriters or have agreed to participate in the distribution, they may, by soliciting such orders, be attempting to induce customers to purchase the security prior to completion of the distribution and thereby violate rule 10b-6 under the Exchange Act [now Rule 101 of Regulation M].'' *See also Report of the Securities and Exchange Commission Concerning the Hot Issues Markets* at 37–38 (August 1984) (1984 Hot Issues Report) (requiring customers who receive IPO allocations to purchase shares in the aftermarket stimulates demand for the security and causes shares to trade at a premium in the aftermarket). As Staff Legal Bulletin No. 10. discussed: ''Solicitations and tie-in agreements for aftermarket purchases are manipulative because they undermine the integrity of the market as an independent pricing mechanism for the offered security. Solicitations for aftermarket purchases give purchasers in the offering the impression that there is scarcity of the offered securities. This can stimulate demand and support the pricing of the offering.''

[15] *See SEC* v. *Burns,* 614 F. Supp. 1360 (S.D.Cal. 1985), *aff'd on other grounds,* 816 F.2d 471, 477 (9th Cir. 1987) (finding that ''[s]o long as the participant attempted to induce purchases of those securities involved in the distribution, and did so before he completed his participation in the distribution, the attempt to induce comes within the scope of Rule 10b-6''). *See also Michael J. Markowski,* Securities Exchange Act Release No. 44086 (March 20, 2001) (finding a Rule 10b–6 violation when a broker-dealer firm instructed its brokers to solicit aftermarket orders during the distribution).

[16] Regulation M Concept Release, 59 FR at 21687.

[17] ''Regulation M proscribes certain activities that offering participants could use to manipulate the price of an offered security * * *. The Commission continues to believe that a prophylactic approach to anti-manipulation regulation is the most effective means to protect the integrity of the offering process

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particular conduct is a proscribed attempt to induce to bid for or purchase a covered security requires an analysis of all of the facts and circumstances surrounding the distribution participant's activity.

We are not addressing here the full spectrum of conduct prohibited by Regulation M. Rather, our discussion is focused on applying Regulation M to particular facts and circumstances that we have observed occurring in the most recent hot IPO market and providing guidance on some types of activities that are impermissible in light of the requirements of Regulation M.

III. Regulation M and IPOs

A. ''Hot'' IPO Periods

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 when the trading market in the newly issued securities first commences (*i.e.*, the ''aftermarket''). ''Hot'' IPO markets present special problems in this context.[18] By definition, hot IPO markets are characterized by high levels of demand for an allocation of the IPO shares in the original distribution, and therefore the shares are a valuable commodity. Underwriters may therefore be tempted to demand, require, solicit, encourage, or otherwise attempt to induce investors to engage in immediate aftermarket transactions in order to obtain an allocation of IPO shares.[19] Such activity violates Regulation M and also may violate the general antifraud and anti-manipulation provisions of the securities laws.[20]

The Special Study in 1963 that focused on the ''hot issue'' market from 1959–1961[21] found that ''[i]n the pricing of new issues, underwriters could not help but be influenced by the knowledge that the prices of many issues would subsequently rise in the immediate after-market * * *''[22] The Special Study identified a number of problems and abuses that resulted from this knowledge, including the solicitation of aftermarket purchases.[23] The Special Study found that, while it was often difficult to determine whether solicitation of purchases in the aftermarket occurred prior to or immediately following the effective date of the offering, customers of certain distribution participants engaged in significant market purchases on the first day of trading, thus suggesting that the participants actively solicited or recommended purchases at least as early as the notice of effectiveness.[24]

Subsequent studies also discussed underwriters' conduct in connection with IPOs.[25] We issued a report in 1984 analyzing the hot issue market from 1980–1983.[26] Among other things, the 1984 Report found that underwriters used ''tie-in'' arrangements requiring customers, as a condition of participation in a hot issue offering, either to agree to purchase additional shares of the same issue at a later time, or to participate in another offering.[27] Most recently, the NYSE/NASD IPO Advisory Committee issued a report in May 2003 discussing underwriters' conduct during the IPO ''bubble'' of the late 1990s and 2000, a period in which there were an unusually large number of IPOs that traded ''at extraordinary and immediate aftermarket premiums.''[28] The report found that among the most harmful practices that artificially inflated aftermarket prices were ''allocating IPO shares based on a potential investor's commitment to purchase additional shares in the aftermarket at specified prices,'' which the report referred to as ''laddering.''[29]

B. Book-Building

Book-building refers to the process by which underwriters gather and assess potential investor demand for an offering of securities and seek information important to their determination as to the size and pricing of an issue.[30] When used, the IPO book-building process begins with the filing of a registration statement with an initial estimated price range. Underwriters and the issuer then conduct ''road shows'' to market the offering to potential investors, generally institutions. The road shows provide investors, the issuer, and underwriters the opportunity to gather important information from each other. Investors seek information about a company, its management and its prospects, and underwriters seek information from investors that will assist them in determining particular investors' interest in the company, assessing demand for the offering, and improving pricing accuracy for the offering. Investors' demand for an offering necessarily depends on the value they place, and the value they expect the market to place, on the stock, both initially and in the future. In conjunction with the road shows, there are discussions between the underwriter's sales representatives and prospective investors to obtain investors' views about the issuer and the offered securities, and to obtain indications of the investors' interest in purchasing quantities of the underwritten securities in the offering at particular prices.[31] As the IPO Advisory

by precluding activities that could influence artificially the market for the offered security.'' Regulation M Adopting Release, 62 FR at 520. *See also* Regulation M Proposing Release, 69 FR at 75775 (stating '' * * * Regulation M does not require the Commission to prove in an enforcement action that distribution participants have a manipulative intent or purpose'').

[18] *See* IPO Advisory Committee Report at 1–2, stating:

In recent years, however, public confidence in the integrity of the IPO process has eroded significantly. Investigations have revealed that certain underwriters and other participants in IPOs at times engaged in misconduct contrary to the best interests of investors and our markets * * * Instances of this behavior became more frequent during the IPO ''bubble'' of the late 1990s and 2000 * * *.

[19] *See* IPO Advisory Committee Report at 1 (discussing underwriters' misconduct during the IPO ''bubble'' of the late 1990s and 2000).

[20] ''Any transaction or any series of transactions, whether or not effected pursuant to the provisions of Regulation M * * * remain subject to the antifraud and antimanipulation provisions of the securities laws * * *.'' 17 CFR 242.100(a).

[21] Special Study, pt. 1.

[22] Special Study, pt. 1, at 554. *See also* IPO Advisory Committee Report, similarly noting that during the late 1990s and 2000, the ''large first-day price increases affected the allocation process by creating a pool of instant profits for underwriters to distribute.'' *Id.* at 1.

[23] Special Study, pt. 1, at 520–21, 556. *See supra* note 14.

[24] Special Study, pt. 1, at 556 (also finding that ''[t]o add to the aftermarket excitement, some managing underwriters arranged for solicitation of customers at premium prices through nonparticipating firms.'') *See also* David Clurman, *Controlling a Hot Issue Market,* 56 Cornell L. Rev. 74, 76 (1970).

[25] *See, e.g.*, IPO Advisory Committee Report.

[26] ''Report of the Securities and Exchange Commission Concerning Hot Issues Markets'' (August 1984) (1984 Hot Issues Report).

[27] 1984 Hot Issues Report, at 37–39. ''This practice stimulates demand for a hot issue in the aftermarket thereby facilitating the process by which stock prices rise to a premium.'' *Id.* at 37–38. We have stated that ''making allotments to customers only if such customers agree to make some comparable purchase in the open market after the issue is initially sold'' may violate the anti-manipulative provisions of the Securities Exchange Act of 1934 (Exchange Act), particularly Rule 10b–6 (which was replaced by Rules 101 and 102 of Regulation M), and may violate other provisions of the federal securities laws. Securities Exchange Act Release No. 6536 (April 24, 1961).

[28] IPO Advisory Committee Report, at 1.

[29] IPO Advisory Committee Report, at 2. The Report described ''laddering'' as inducing investors to give orders to purchase shares in the aftermarket at pre-arranged, escalating prices in exchange for receiving IPO allocations, and stating that ''[t]his conduct distorts the offering and the aftermarket and impairs investor confidence in the IPO process.'' *Id.* at 6.

[30] *See In re Initial Public Offering Securities Litigation,* 241 F. Supp. 2d 281, 388 n. 106 (S.D.N.Y. 2003) (book-building ''entails the lead underwriter gathering and assessing potential investors'' demand for the offering'').

[31] *See* IPO Advisory Committee Report, at 5–6. Actual sales or contracts for sale are prohibited

Committee Report stated: ''[C]ollecting information about investors'' long-term interest in, and valuation of, a prospective issuer is an essential part of the book-building process.'' [32] By aggregating information obtained during this period from investors with other information, the underwriters and the issuer will agree on the size and pricing of the offering, and the underwriters will decide how to allocate the IPO shares to purchasers.[33]

Information that underwriters typically attempt to gather from prospective investors during the book-building process for an IPO, whether in high demand or not, includes: [34]

- A customer's evaluation of the issuer's products, earnings, history, management, and prospects.
- A customer's valuation of the securities being offered.
- The amount of shares a customer seeks to purchase *in the offering* at particular price levels (*i.e.*, indications of interest or conditional offers to buy).
- Whether the customer owns similar securities in his portfolio.
- At what prices the customer expects the shares will trade after the offering is completed (*e.g.*, where the stock will be trading three to six months after the offering).
- Whether the customer intends to hold the securities as an investment (be a long-term holder), or, instead, expects to sell the shares in the immediate aftermarket (also known as ''flipping'').
- The customer's desired long-term future position in the security being offered or in the relevant industry, and the price or prices at which the customer might accumulate that position.

C. The Application of Regulation M to Book-Building Activities

While we recognize the importance of the book-building process in obtaining and assessing demand for an offering and in pricing the securities, we remind market participants that there is no ''book-building exception'' to Regulation M for inducing or attempting to induce aftermarket bids or purchases.[35] Although a distribution participant's obtaining and assessing information about demand for an offering during the book-building process would not, by itself, constitute an inducement or attempt to induce, accompanying conduct or communications, including one or more of the activities described below, may cause the collection of information to be part of conduct that violates Regulation M.

Underwriters and other distribution participants must take care that their activities do not cross the line into prohibited attempts to induce aftermarket bids or purchases by prospective investors or others. Regulation M's proscription of attempts to induce bids and purchases ''covers activity that causes or is likely to cause another person to bid for or purchase covered securities.'' [36] The determination as to 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 surrounding such activity or communication.

D. Prohibited Attempts To Induce

As we previously stated, the purpose of this release is to provide guidance under Regulation M with respect to book-building and the process for allocating shares in IPOs. The activities we emphasize are prohibited do not represent an exhaustive list of conduct that violates Regulation M because the facts and circumstances of particular communications or activities will determine whether there is a Regulation M violation. This 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 of an offered security, in relation to an expected allocation of IPO shares, is impermissible under Regulation M. We are not suggesting however that conduct is improper simply because it ascertains an investor's interest in purchasing an issuer's securities or leads to the development by an investor of an interest in purchasing securities of an issuer, whether in the offering or the aftermarket, including as a result of communications between the investor and a distribution participant regarding the issuer or the offering.

IV. Commission Guidance

The Commission has determined in the context of recent enforcement actions that the following activities and conduct during the Regulation M restricted period violated Regulation M:[37]

1. *Inducements to purchase in the form of tie-in agreements* [38] *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 (''aftermarket interest'') or immediate aftermarket buying would help them obtain allocations of hot IPOs.* The focus of this communication is clearly to attempt to induce customers to bid for or purchase securities in the immediate aftermarket in return for an allocation. However, inquiring as to customers' desired future position in the longer term (for example, three to six months) and the price or prices at which customers might accumulate that position, without reference to immediate aftermarket activity, does not, without more, fall within this violative conduct.

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 stock.*[39]

during the period prior to the registration statement for the offering becoming effective. 15 U.S.C. 77e.

[32] IPO Advisory Committee Report, at 6.

[33] *See* IPO Advisory Committee Report, at 4 (stating ''[t]he pricing of an IPO is a business decision reached by the issuer in consultation with the underwriter''). *See also* Jay R. Ritter, *Initial Public Offerings,* Contemporary Finance Digest, Vol. 2, No. 1 (Spring 1998), pp. 5–30, at § 7.1 at pp. 19–21.

[34] This is not an exhaustive list of all the information gathered during the book-building process.

[35] The exception in Rule 101(b)(9) of Regulation M for offers to sell or the solicitation of offers to buy the security being distributed does not extend to inducements or attempts to induce bids or purchases in the aftermarket while the distribution is occurring.

[36] Regulation M Concept Release, 59 FR at 21687.

[37] The Commission has recently brought enforcement cases alleging violations of Regulation M. *See SEC* v. *Morgan Stanley & Co.*, (Compl.) (2005); *SEC* v. *Goldman Sachs & Co.*, (Compl.) (2005); *SEC* v. *J.P. Morgan Securities, Inc.*, (Compl.) (2003). *See also Michael J. Markowski, supra* note 16 and Securities Exchange Act Release No. 6536, *supra* note 3 (describing violations of Rule 10b–6, the predecessor to Regulation M).

[38] In this context, tie-in agreements are agreements or contracts for the purchase of shares in the aftermarket in exchange for an allocation. Such contracts may also violate the antifraud provisions of the Securities Act of 1933 (Securities Act) and the Exchange Act, and Section 5 of the Securities Act. *See* Special Study, pt. 1, at 521 n. 93. *See also* Staff Legal Bulletin No. 10. The solicitation of a tie-in is prohibited, irrespective of whether an agreement or contract to purchase results.

[39] We note that the district court in *In re Initial Public Offering Antitrust Litigation*, 287 F. Supp. 2d 497 (S.D.N.Y. Nov. 3, 2003), appeal pending, *Billing* v. *Credit Suisse First Boston*, Nos. 03–9284, 03–9288 (2d Cir.) stated that ''inquiries of customers or others interested in purchasing Class Securities concerning the number of shares that such person would be willing to purchase in the aftermarket and the prices such person would be willing to pay for the shares' are actions that are ''expressly permitted during the 'road show' period.'' Id. at 508. However, no provision of the federal securities laws expressly permits the conduct described in the quotations during the ''road show'' period. In fact, depending on the facts and circumstances, if the ''road show'' period overlaps with a restricted period defined in Regulation M, then such actions may represent

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Where the sales representative inquires whether the customer intends to place orders in the immediate aftermarket, and if so, at what prices and quantities, the clear expectation and understanding is that the customer will submit aftermarket orders at the prices and quantities discussed if the customer receives an allocation of shares. However, inquiring as to a customer's desired future position in the longer term (for example, three to six months), and the price or prices at which the customer might accumulate that position without reference to immediate aftermarket activity, does not, without more, fall within this violative conduct. Soliciting aftermarket interest from customers that the distribution participant knows, or should know, have no interest in long-term holdings of the stock of IPO companies, may show that the firm or salesperson was attempting to induce aftermarket activity.

4. *Proposing aftermarket prices to customers or encouraging customers who provide aftermarket interest to increase the prices that they are willing to place orders in the immediate aftermarket.* Proposing aftermarket prices to customers creates the impression of a strong offering demand and a scarcity of offering shares, which can facilitate a distribution. Encouraging customers who provide aftermarket interest to increase the price level at which they were willing to place orders in the aftermarket conveys to customers that bidding for or purchasing in the immediate aftermarket at price levels higher than their own initial price level or higher than other customers' aftermarket price levels is expected in consideration for an allocation or an improved allocation in the IPO. Communication to customers of information obtained from third parties regarding their valuation of an issuer or the offering price is not violative where the conduct would not be likely to cause the customer to express an interest in paying a higher price in the immediate aftermarket. Encouraging an increase in prices, including by communication of 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 as described above.

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 (''1 for 1'') 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.* By seeking this type of aftermarket interest from customers, the underwriter would be attempting to induce customers to place orders or buy in the aftermarket. In contrast, it is possible that a customer could express a desire to purchase in the aftermarket without prompting from the salesman. Where the customer's statement is spontaneous, there may be no ''attempt to induce'' by the salesperson. However, if, for example, there had been a prior course of dealing between the firm and the investor through which the firm communicated that the investor was expected to provide this type of aftermarket price and quantity information, the seemingly spontaneous statement of an intention to make aftermarket purchases may in fact have been induced by the firm. In any event, whether or not the customer's statement is spontaneous, if a sales representative accepts a customer's offer to purchase shares in the immediate aftermarket that is expressly linked to the receipt of an allocation, this is a prohibited tie-in agreement and violates Regulation M.[40]

6. *Soliciting aftermarket orders from customers before all IPO shares are distributed or rewarding customers for aftermarket orders by allocating additional IPO shares to such customers.* If all of the IPO shares have not been distributed, an underwriter is still in a restricted period and prohibited from attempting to induce aftermarket activity.[41] By soliciting orders or rewarding customers who place orders in the immediate aftermarket with additional IPO shares in the same offering, the underwriter is 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 other hot IPOs.* In this scenario, 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 hot IPOs. However, determining that a customer is or may be a long-term investor in the securities of an issuer or one or more other issuers and communications with a customer in connection with that determination do not, in and of themselves, violate Regulation M, whether or not a customer engages in aftermarket bids or purchases.

Each of the above activities is an improper attempt to induce investors to bid for or purchase covered securities in the aftermarket in order to receive IPO allocations.[42] These solicitations or attempts to induce aimed at aftermarket transactions tend to: (1) Create offering demand; (2) cause artificial aftermarket price escalation; and (3) erode market integrity. As we have stated before, 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.[43] 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.

In addition, certain conduct occurring after the restricted period, while not of itself illegal, could be evidence that a distribution participant attempted during the restricted period to induce customers to bid for or purchase stock in the aftermarket.[44] Recent

attempts to induce aftermarket bids or purchases in violation of Rule 101 of Regulation M.

[40] By accepting such a commitment, the firm also may violate Section 5 under the Securities Act. *See* Special Study, pt. 1, at 521 n. 93. *See also* note 38 *supra.* In contrast, for example, where a sales representative rejects the offer to make aftermarket purchases linked to the receipt of an allocation, and informs the customer that firm policy prohibits allocations on that basis, the firm would not have engaged in activity that constitutes a prohibited tie-in agreement in violation of Regulation M, notwithstanding that the customer ultimately was allocated IPO shares.

[41] The definition of restricted period in Rule 100 of Regulation provides that a restricted period ends upon ''such person's completion of participation in the distribution.'' In the Adopting Release the Commission stated, ''[u]nder Regulation M, a person determines when its completion of participation in the distribution occurs based on the person's role in the distribution. An underwriter is deemed to have completed its participation in a distribution when its participation has been distributed * * * and after any stabilization arrangements and trading restrictions in connection with the distribution have been terminated. The definition contains a provision that an underwriter's participation is not deemed to be completed, however, if a syndicate overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of such exercise.'' Regulation M Adopting Release, 62 FR at 522.

[42] We note, however, that allocating offering shares in an amount less than the investor's indication of interest for shares in the offering in response to a solicitation to purchase in the offering would not, in and of itself, be considered an attempt to induce aftermarket purchases.

[43] *See* 1984 Hot Issue Report, at 37–39.

[44] As discussed above, while aftermarket transactions can serve as evidence that there had been an attempt to induce aftermarket bids or purchases, such evidence is not required to establish an attempt to induce in violation of Regulation M. Additionally, oral attempts to induce aftermarket activity can be evidenced in a variety of ways. *See, e.g., Americorp, Inc.*, Securities

enforcement cases contain examples of such activity including: (1) Follow-up solicitations for immediate aftermarket orders from customers who had provided aftermarket interest earlier; and (2) tracking or monitoring customers' aftermarket purchases to see whether they had followed through on their aftermarket interest.[45] We recognize that there are legitimate reasons to monitor customer activity. However, tracking customers' aftermarket purchases in the first few days of trading following an IPO could be evidence supporting a claim that the customers' expressions of desire to purchase in the aftermarket were induced.

V. Policies and Procedures

Underwriters should have 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.[46] Firms should implement policies that, at a minimum, prohibit and monitor for the activities discussed in this release. Procedures and systems for applying policies should be in place so that sales representatives and other firm employees are reasonably supervised with a view to preventing and detecting improper attempts to induce aftermarket bids or purchases during a restricted period. Firms also should take corrective action if breaches occur.

VI. General Request for Comment

We will continue to monitor developments in IPO allocation practices. We invite anyone who is interested to submit written comments on this release. Additionally, the Commission solicits comment generally concerning underwriter conduct in connection with IPOs and other distributions. The Commission will take these comments into consideration as it considers future rulemaking.

List of Subjects in 17 CFR Parts 231, 241, and 271

Securities.

Amendments to the Code of Federal Regulations

■ For the reasons set out in the preamble, the Commission is amending Title 17, chapter II of the Code of Federal Regulations as set forth below:

PART 231—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES ACT OF 1933 AND GENERAL RULES AND REGULATIONS THEREUNDER

■ Part 231 is amended by adding Release No. 33–8565 and the release date of April 7, 2005 to the list of interpretive releases.

PART 241—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

■ Part 241 is amended by adding Release No. 34–51500 and the release date of April 7, 2005 to the list of interpretive releases.

PART 271—INTERPRETATIVE RELEASES RELATING TO THE INVESTMENT COMPANY ACT OF 1940 AND GENERAL RULES AND REGULATIONS THEREUNDER

■ Part 271 is amended by adding Release No. IC–26828 and the release date of April 7, 2005 to the list of interpretive releases.

By the Commission.

Dated: April 7, 2005.

Margaret H. McFarland,

Deputy Secretary.

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Exchange Act Release No. 41728 (August 11, 1999) (broker dealer representatives prepared order tickets for aftermarket orders prior to the IPO becoming effective).

[45] For example, the sales representative may call the investor when aftermarket trading begins and ask why an order had not been received from the investor; or the investor may be informed that he is being penalized for not making aftermarket purchases by being denied allocations in future IPOs.

[46] *See, e.g.*, Exchange Act Section 15(b)(4)(E), 15 U.S.C. 78o(b)(4)(E). *See also* NASD Rule 3010(a) (requiring member firms to establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable NASD rules, federal securities laws and rules); NASD Notice to Members 03–72, *Request for Comment on Regulatory Approaches to Enhance IPO Pricing Transparency* (November 2003); IPO Advisory Committee Report, at 6, 19 (encouraging underwriters to develop effective internal policies and procedures to prevent prohibited secondary market activity and recommending that underwriters impose additional requirements to promote the highest standards of conduct, including: (1) enhanced periodic internal review by the underwriter of its IPO supervisory procedures; and (2) a heightened focus on the IPO process in SRO examinations for investment banking personnel).