

SECURITIES ALERT

SEC ISSUES GUIDANCE REGARDING PROHIBITED CONDUCT IN CONNECTION WITH IPO ALLOCATIONS



On April 7, 2005, the Securities and Exchange Commission (the SEC) issued an interpretive release providing guidance under Regulation M aimed at underwriters with respect to book-building and the process for allocating shares in initial public offerings (IPOs). The release highlights certain activities that underwriters should avoid during restricted periods under Regulation M and distinguishes permissible book-building conduct from the proscribed activities. The SEC encourages underwriting firms to adopt policies and procedures to detect and prevent proscribed conduct and to take corrective action if transgressions occur.

REGULATION M

Regulation M prohibits underwriters and others from bidding for, purchasing or attempting to induce any person to bid for or purchase, an offered security during a restricted period as defined in Regulation M. With respect to an IPO, the restricted period currently begins five business days prior to the determination of an offering price and ends upon a person's completion of participation in the distribution.¹ Since Regulation M applies to attempts, conduct is prohibited whether or not it actually results in market activity by others. With respect to prohibited activity, the SEC has said that "inducements to purchase" broadly refers to "activity that causes or is likely to cause another person to bid for or purchase covered securities." The SEC's guidance focuses on "hot" IPO markets, which are characterized by high levels of demand for an allocation of the IPO shares in the original distribution. The SEC suggests that in a hot IPO market, underwriters may be tempted to demand, require, solicit, encourage or otherwise attempt to induce investors to engage in immediate aftermarket transitions in order to obtain an allocation of IPO shares.

¹ In December 2004 the SEC published for comment proposed amendments to Regulation M which provide that the restricted period would begin when a broker-dealer reaches an understanding with respect to a distribution. The SEC indicated in its April 2005 interpretive release that its guidance in the release is consistent with the proposed amendments.

BOOK-BUILDING AND IPO ALLOCATION PROCESS

Book-building refers to the process by which underwriters assess potential investor demand for an offering of securities and seek information important to their determination as to size and price of an issue. The IPO book-building process begins with the filing of a registration statement containing an initial estimated price range. Underwriters and issuers then conduct “road shows” to market the offering to potential investors. In conjunction with the road shows, there are discussions between the underwriters and prospective investors to gauge long-term interest in, and valuation of, a prospective issuer. 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.

PROHIBITED CONDUCT IN CONNECTION WITH IPO ALLOCATIONS

The SEC indicates that whether conduct constitutes legitimate book-building or an attempt to induce a bid or purchase in violation of Regulation M generally depends on the particular facts and circumstances surrounding such conduct. However, the SEC has determined after reviewing three recent enforcement cases that the following activities and conduct during a Regulation M restricted period violate Regulation M:

- ***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.*** Tie-in agreements are contracts for the purchase of shares in the aftermarket in exchange for an IPO allocation. The solicitation of tie-ins is prohibited, whether or not an agreement or contract to purchase results.
- ***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 SEC states, however, that 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.
- ***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.*** Again, inquiring about customers’ desired future position in the longer term 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.
- ***Proposing aftermarket prices to customers or encouraging customers who indicate aftermarket interest to increase the prices that they are willing to place orders in the immediate aftermarket.*** Communication to customers of information obtained from third parties regarding their valuation of an issuer or the offering price is not violative, if the communication would not be likely to cause the customer to express an interest in paying a higher price in the immediate aftermarket. However, communicating prices anticipated to be offered by third parties in the aftermarket would be deemed improper because it would be viewed as improperly conveying to a customer that a commitment in the aftermarket at higher price levels is expected.
- ***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 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.*** The SEC acknowledges that where a customer expresses a desire to purchase in the aftermarket without prompting from the salesman or a prior course of dealing suggesting that the investor was expected to

provide this type of aftermarket price and quantity information, there may be no “attempt to induce” by the salesperson. Furthermore, even if 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.

- ***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.*** The SEC indicates that when an underwriter solicits orders or rewards customers who place orders in the immediate aftermarket with additional IPO shares in the same offering, the underwriter is improperly stimulating aftermarket purchasers during the restricted period.
- ***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.*** 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 communicating 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.

POLICIES AND PROCEDURES

The SEC states that underwriters should have effective policies and procedures to detect and prevent prohibited solicitations, tie-in agreements, other attempts to induce aftermarket bids or purchases during the Regulation M restricted period. The SEC states that such policies should, at a minimum, prohibit and monitor for the activities discussed in the SEC’s release. According to the SEC, procedures and systems for applying policies should be in place so that sales representatives and other firm employees are reasonably supervised, and underwriting firms should take corrective action if breaches occur.

CONTACT INFORMATION

If you have questions or would like to learn more about this topic, please contact the partner who represents you, or:

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