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CLIENT MEMORANDUM

SEC PROVIDES GUIDANCE REGARDING CONDUCT IN CONNECTION WITH IPO ALLOCATIONS

The Securities and Exchange Commission recently issued an interpretive release providing guidance under Regulation M with respect to the process known as "book-building," including the process for allocating shares in initial public offerings ("IPOs").[1] The release summarizes three enforcement cases the Commission recently brought alleging abuses in the offering process.

I. Overview of Regulation M

Regulation M precludes activities that could condition the market for an offered security. Rule 101 of Regulation M, applicable to underwriters and other distribution participants, restricts, among other things, bids and purchases, and inducements to bid or purchase a covered security during the distribution's restricted period. The Commission in this release warns that 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. Attempts to induce aftermarket bids or purchases, the Commission states, can give prospective IPO purchasers the impression that there is a scarcity of the offered securities and that the balance of their buying interest therefore can only be satisfied in the aftermarket.

Regulation M applies both to attempts and inducements, meaning that the rule covers conduct irrespective of whether it actually results in market activity, and covers activity that causes or is likely to cause another to bid or purchase covered securities. The Commission's interpretive release focuses on the application of Regulation M to the recent "hot" IPO market. Hot IPO markets present special problems in the Commission's view, because allocations of the shares at the public offering price are a valuable commodity and underwriters may be tempted to induce investors to engage in immediate aftermarket transactions to obtain an allocation.

II. Issues Concerning Book-Building

In gathering and assessing potential investor demand for an offering, underwriters typically seek information from their investor clients concerning the investor's evaluation of the long-term prospects of the issuer, the price at which the investor expects the shares will trade in the after-market and the duration the investor plans to hold the shares. The Commission made it clear in the interpretive release that an underwriter's obtaining and assessing information about demand for an offering during the book-building process does not, without more, constitute a Regulation M violation, but it stated there is no "book-building" exemption to Regulation M and that conduct or communications accompanying collection of information may constitute an inducement to trade that violates Regulation M.

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[1] SEC Release No. 33-8565 (April 7, 2005).

III. Commission Guidance

The Commission emphasized that Regulation M prohibits 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. While not an exhaustive list, the Commission has determined the following seven activities during the restricted period violate Regulation M:

1. *Inducements to purchase, in the form of tie-in agreements (agreements to purchase shares in the aftermarket in exchange for an IPO allocation), prior to the completion of the distribution*.

2. *Communicating to customers that expressing an interest in or buying shares in the immediate aftermarket would help them obtain allocations of hot IPOs*. On the other hand, asking a client what his desired long-term future position would be and the price at which he might accumulate that position, without reference to immediate aftermarket activity, would not, without more, constitute a violation.

3. *Soliciting customers before the completion of the distribution about whether and at what price and in what quantity the customer intends to place immediate aftermarket orders for IPO stock where 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.* Again, underwriters are not prohibited from discussing a customer's desired future position in the longer term and the price at which the customer might accumulate that position without reference to the immediate aftermarket.

4. *Proposing aftermarket prices to customers or encouraging customers who express aftermarket interest to increase the prices at which they are willing to place orders in the immediate aftermarket*. The Commission believes such a proposal to a customer creates the false impression of a stronger offering, while encouraging customers interested in the aftermarket to raise the price they are willing to pay creates the impression that a higher bid price is expected in consideration for an IPO allocation. Nonetheless, communication to customers concerning a third party's valuation of an issuer or the offering price would not violate Regulation M if the communication would not be likely to cause the customer to pay a higher aftermarket price.

5. *Soliciting interest from customers in purchasing aftermarket shares in some fixed proportion to the customer's IPO allocation*. While the Commission believes Regulation M is not violated if the customer expresses unsolicited interest in purchasing aftermarket shares, a violation would occur where the client, through his or her prior course of dealing with the underwriter, understands he is expected to purchase aftermarket shares in order to receive an IPO allocation.

The Commission indicates that if the sales representative rejects the offer to make aftermarket purchases linked to an allocation and informs the client that firm policy prohibits allocations on that basis, the firm would not be in violation even if it does allocate shares to the customer.

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*. The underwriter must not attempt to induce aftermarket activity until all the IPO shares have been distributed.

7. *Communicating to customers in connection with one offering that expressing an interest or buying in the aftermarket would help them obtain IPO allocations of other hot IPOs*. While an underwriter may seek to determine whether a customer may be a long-term investor in the other issuer, the underwriter may not attempt to induce the customer to purchase aftermarket shares in exchange for an IPO allocation in another company.

The Commission stated that the above activities violate Regulation M because they tend to: (a) create offering demand; (b) cause artificial aftermarket price escalation by manufacturing the perception of scarcity; and (c) erode market integrity by making it difficult for investors to determine whether aftermarket demand has been stimulated by the underwriters' unlawful conduct. The Commission noted that some legal conduct during the restricted period may be viewed as evidence of an attempt to induce an aftermarket purchase such as follow-up solicitations for immediate aftermarket orders from customers who had provided aftermarket interest earlier and tracking or monitoring customers' aftermarket purchases to see whether they had followed through on their aftermarket interest.

IV. Recommended Policies

The Commission recommends that underwriters put in place 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. Procedures 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.

V. Comment Solicitation

The Commission is soliciting comments on the Release as well as general comments related to underwriter conduct in connection with IPOs and other distributions.

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If you have any questions concerning the foregoing or would like further information, please call Roger D. Blanc at (212) 728-8206, Martin Miller at (212) 728-8690, or the attorney with whom you regularly work.

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