

SECURITIES AND EXCHANGE COMMISSION

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RIN 3235-AF54

Anti-manipulation Rules Concerning Securities Offerings

AGENCY: Securities and Exchange Commission.

ACTION: Final rules.

SUMMARY: The Commission is adopting new Regulation M governing the activities of underwriters, issuers, selling security holders, and others in connection with offerings of securities. Regulation M is intended to preclude manipulative conduct by persons with an interest in the outcome of an offering. Regulation M significantly eases regulatory burdens on offering participants by eliminating the trading restrictions for underwriters of actively-traded securities; reducing the scope of coverage for other securities; reducing restrictions on issuer plans; providing a more flexible framework for stabilizing transactions; and deregulating rights offerings. Consisting of five new rules, plus a new definitional rule, Regulation M replaces Rules 10b-6, 10b-6A, 10b-7, 10b-8, and 10b-21 ("trading practices rules") under the Securities Exchange Act of 1934 ("Exchange Act"), which are being rescinded. In addition, related amendments are being made to Items 502(d) and 508 of Regulations S-B and S-K, and to Rules 10b-18 and 17a-2 under the Exchange Act. Conforming changes to various rules under the Securities Act of 1933 ("Securities Act") and the Exchange Act are being made to reflect the repeal of the trading practices rules and the adoption of Regulation M.

EFFECTIVE DATE: March 4, 1997. The requirement of § 242.104(i) and the amendments to § 240.17a-2 are effective on April 1, 1997.

FOR FURTHER INFORMATION CONTACT: Any of the following attorneys in the Office of Risk Management and Control, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 5-1, Washington, D.C. 20549, at 202-942-0772: Nancy J. Sanow, M. Blair Corkran, Carlene S. Kim, Heidi E. Pilpel, Barbara J. Endres, Irene A. Halpin, Marc J. Hertzberg, Denise M. Landers, Lauren C. Mullen, Mark R. Pacioni, Alan J. Reed, or Margaret A. Smith.

SUPPLEMENTARY INFORMATION:

I. Introduction and Summary of New Regulation M

A fundamental goal of the federal securities laws is the prevention of manipulation. Manipulation impedes the securities markets from functioning as independent pricing mechanisms, and undermines the integrity and fairness of those markets. Congress granted the Commission broad rulemaking authority to combat manipulative abuses in whatever form they might take. In exercising its authority, the Commission has focused on the market activities of persons participating in a securities offering, and determined that securities offerings present special opportunities and incentives for manipulation that require specific regulatory attention.

On April 11, 1996, the Commission published for comment a release ("Proposing Release") proposing Regulation M, and Rules 100 through 105 thereunder, to govern the activities of issuers, underwriters, and other persons participating in a securities offering,¹ and to replace Rules 10b-6, 10b-6A, 10b-7, 10b-8, and 10b-21² under the Exchange Act.³ The Commission received 39 comment letters from 36 commenters in response to the Proposing Release.⁴ The commenters generally expressed strong support for proposed Regulation M, although several expressed concerns with specific provisions, and some suggested alternative approaches for addressing particular issues. The Commission is adopting Regulation M substantially as proposed, but with some modifications to clarify provisions or to reflect commenters' views. The new regulation represents the most significant changes to the Commission's anti-manipulation regulation of securities offerings since the adoption of the trading practices rules over 40 years ago.⁵

Regulation M is the culmination of a comprehensive review by the Commission of its anti-manipulation regulation of securities offerings.⁶ This

¹ Securities Exchange Act Release No. 37094 (April 11, 1996), 61 FR 17108.

² 17 CFR 240.10b-6, 240.10b-6A, 240.10b-7, 240.10b-8, and 240.10b-21.

³ 15 U.S.C. 78a *et seq.*

⁴ A summary of comments has been prepared by the staff of the Division of Market Regulation. The summary is included, along with the comment letters, in Public File No. S7-11-96, which is available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

⁵ See Securities Exchange Act Release No. 5194 (July 5, 1995), 20 FR 5075.

⁶ See Securities Exchange Act Release No. 33924 (April 19, 1994), 59 FR 21681 ("Concept Release").

review was prompted by ongoing developments and innovations in the securities industry, including: increasing institutionalization of the markets, advances in technology and communications media, enhanced surveillance capabilities, continuing globalization of the securities markets, and new offering techniques. These developments have outpaced the existing structure of anti-manipulation regulation of securities offerings and reduced the need for broad prophylactic restrictions. Moreover, the Commission was informed by market participants that the application of the trading practices rules had become needlessly complex and involved substantial compliance costs.

Regulation M exemplifies the Commission's efforts to relax restrictions in cases where either the risk of manipulation is small or the costs of the restrictions are disproportionate to the purposes they serve. The new regulation continues the anti-manipulation objectives of the trading practices rules, but reflects developments in the securities industry, allows greater flexibility for market participants to engage in activities that enhance competition in the marketplace, and incorporates the recommendations of the Commission's Task Force on Disclosure Simplification for a more streamlined approach to regulating manipulative conduct during offerings.⁷ Three of the principal elements that underlie the Commission's decision to provide greater flexibility for market activities during offerings are: securities market transparency, surveillance capabilities of the self-regulatory organizations ("SROs"), and continuing application of the general anti-fraud and anti-manipulation provisions of the federal securities laws, including Section 17(a) of the Securities Act, and Sections 9(a), 10(b), and 15(c) of the Exchange Act, and Rules 10b-5 and 15c1-2 thereunder,⁸ to all activities in connection with an offering, whether or not the provisions of Regulation M apply.⁹ Like the former trading practices rules, Regulation M proscribes certain activities that offering participants could use to manipulate the price of an offered security. Although some

⁷ *Report of the Task Force on Disclosure Simplification*, 77-79 (March 1996) ("Task Force Report").

⁸ 15 U.S.C. 77q(a); 15 U.S.C. 78i(a), 78j(b), and 78o(c); and 17 CFR 240.10b-5 and 240.15c1-2.

⁹ See Proposing Release, 61 FR at 17109. Similarly, Regulation M and the interpretations thereof do not affect the application of the registration and prospectus delivery requirements of the Securities Act to offers and sales of securities.

commenters requested that the rules under Regulation M be formulated as non-exclusive safe harbors from the anti-manipulation provisions of the Exchange Act, 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 by precluding activities that could influence artificially the market for the offered security.

Regulation M contains six rules covering the following activities during a securities offering: (1) activities by underwriters or other persons who are participating in a distribution (*i.e.*, distribution participants) and their affiliated purchasers; (2) activities by the issuer or selling security holder and their affiliated purchasers; (3) Nasdaq passive market making; (4) stabilization, transactions to cover syndicate short positions, and penalty bids; and (5) short selling in advance of a public offering.¹⁰ A separate rule under Regulation M, Rule 100, contains definitional provisions. Some of these definitions are new or revised; many are common to more than one rule. The Commission has endeavored to use straightforward and precise language in both the definitions and rule text.

The provisions of Regulation M that are analogous to Rule 10b-6 are contained in Rules 101 and 102, which cover distribution participants, and issuers and selling security holders, respectively. Rules 101 and 102 apply only during a "restricted period" that commences one or five business days before the day of the pricing of the offered security and continues until the distribution is over. The restricted periods are based on the trading volume value of the offered security and the public float value of the issuer, rather than the price per share and public float criteria used in Rule 10b-6, and generally are of a shorter duration than the cooling-off periods under Rule 10b-6. Furthermore, the restricted periods of Regulation M focus on the time of pricing. In contrast, Rule 10b-6 imposed restrictions during the entire distribution, which could extend over a lengthy period of time, but excepted certain trading activities prior to a two or nine business day "cooling-off

period." The applicable cooling-off period was keyed off the commencement of offers or sales. While Rule 10b-6 was designed to protect the pricing of an offering, certain distribution methods, particularly in connection with foreign offerings, could result in the cooling-off periods commencing after an offering had been priced.

Rule 101 excludes from its coverage more actively-traded securities, nonconvertible and asset backed securities rated investment grade, and Rule 144A transactions. Restrictions on transactions in outstanding debt securities during a distribution of a debt security are narrowed substantially. Further, Rule 101 focuses on the security being distributed and does not cover bids for and purchases of related derivative securities. It permits, among other things, the routine dissemination of research reports, exercises of options and other securities, and transactions in baskets of securities involving the offered security. Also, bids for and purchases of rights during rights offerings are deregulated. Rule 101 deals with "inadvertent" violations during the restricted period by excusing *de minimis* transactions, provided that a distribution participant had in place written policies and procedures reasonably designed to achieve compliance with the regulation. Moreover, the scope of persons subject to Rule 101 is narrowed by recognizing "information barriers" between the distribution participant and its affiliates.

Rule 102 covers issuers, selling security holders, and related persons. The rule allows issuers and selling security holders to engage in market activities prior to the applicable restricted period. It also gives issuers greater flexibility in conducting their dividend reinvestment and stock purchase plans and odd-lot repurchase programs. During the restricted period, Rule 102 permits bids and purchases of odd-lots, transactions in connection with issuer plans, and exercises of options or convertible securities by the issuer's affiliated purchasers, and transactions in commodity pool or limited partnership interests during distributions of those securities. The rule contains a limited exception for actively-traded "reference securities."

Rule 103 replaces Rule 10b-6A and expands the scope of Nasdaq passive market making. The rule covers all Nasdaq securities and nearly all distributions, and permits more distribution participants to engage in passive market making.

Rule 104, which replaces Rule 10b-7, regulates stabilizing and other activities

related to a distribution. The rule provides a more flexible framework for stabilizing transactions than Rule 10b-7. Rule 104 allows underwriters to initiate and change stabilizing bids based on the current price in the principal market (whether U.S. or foreign), as long as the bid does not exceed the offering price. Also, by providing for greater disclosure and recordkeeping of transactions that can influence market prices immediately following an offering, Rule 104 addresses the fact that underwriters now engage in substantial syndicate-related market activity, and enforce penalty bids in order to reduce volatility in the market for the offered security.

Rule 105 recodifies Rule 10b-21 governing short selling in connection with a public offering. To harmonize Rule 105 with the provisions of Rules 101 and 102, the period of Rule 105's coverage is narrowed to the five business day period before pricing, rather than the period extending from the time of filing of offering materials to the time when sales may be made.

The Commission believes that separate regulation of rights offerings, as contained in Rule 10b-8, no longer is warranted. Many rights offerings, especially by foreign issuers, involve securities that fall within the exception for actively-traded securities contained in Rule 101. Even for less actively-traded securities, purchases of rights generally are not an efficient way for a distribution participant to facilitate an offering of the underlying security. Therefore, the Commission has decided to rescind Rule 10b-8.

The new regulatory framework relieves market participants of unnecessary burdens and responds effectively to a changing marketplace, while maintaining essential investor protection. The following sections of this release describe the individual provisions of Regulation M and associated rule changes and discuss, where appropriate, how they differ from the rules as proposed and from the former trading practices rules, as well as reasons for these changes.

II. Discussion of Regulation M and Related Amendments

A. Rule 100—Definitions

Rule 100 sets forth the definitions applicable to all of the rules under Regulation M. Most of the definitions are adopted as proposed; some definitions are revised to respond to commenters' suggestions or to add clarity to the rules. Many of these definitions are discussed later in this release in conjunction with the specific

¹⁰ Regulation M is adopted under the Securities Act, particularly Sections 7, 17(a), and 19(a), 15 U.S.C. 77g, 77q(a), and 77s(a); the Exchange Act, particularly Sections 2, 3, 9(a), 10, 11A(c), 12, 13, 14, 15(c), 15(g), 17(a), 23(a), and 30, 15 U.S.C. 78b, 78c, 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(c), 78o(g), 78q(a), 78w(a), and 78dd; and the Investment Company Act of 1940 ("Investment Company Act"), 15 U.S.C. 80a-1 *et seq.*, particularly Sections 23, 30, and 38, 15 U.S.C. 80a-23, 80a-29, and 80a-37.

provisions of Regulation M to which they relate.¹¹

B. Rule 101—Activities by Distribution Participants

1. Generally

Rule 101 governs the activities of persons participating in *distributions* of securities, other than issuers or *selling security holders*, and their *affiliated purchasers*. The distribution participants subject to Rule 101 will typically be financial intermediaries that routinely engage in market transactions for their own accounts or for customers as part of their businesses.

In general, Rule 101 prohibits distribution participants and their affiliated purchasers from bidding for, purchasing, or attempting to induce any person to bid for or purchase, a *covered security* during a specified period (*restricted period*). As with Rule 10b-6(c)(5), a distribution of securities under Regulation M is distinguished from ordinary trading transactions by the "magnitude of the offering" and the presence of "special selling efforts and selling methods."¹² The restricted period for a particular distribution commences one or five *business days* before the day of the pricing of the offered security and continues until the distribution is over.¹³

Even during the restricted period, Rule 101 permits distribution participants and their affiliated purchasers to engage in a variety of activities, including the following: the routine dissemination of research reports; exercises of options and other securities, including rights received in connection with a rights offering; transactions in baskets of securities involving an offered security; and certain transactions involving Rule 144A securities of foreign and domestic issuers. Rule 101 also excepts *de minimis* transactions that would otherwise violate the rule: bids that are not accepted, and one or more purchases that in the aggregate over the restricted period total less than 2% of the security's average daily trading volume, provided that the person making the unaccepted bids or purchases has maintained and enforced

written policies and procedures designed to achieve compliance with the rule.

2. Persons Subject to Rule 101

a. Distribution Participant

A *distribution participant* is defined in Rule 100 as an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution. The Commission is adopting the definition as proposed.

Several commenters expressed concern that a distribution participant affiliated with an issuer or selling security holder (e.g., an underwriter that is affiliated with an issuer) would be subject to the more restrictive provisions of Rule 102, rather than those of Rule 101, which they claimed could result in unwarranted adverse business and market consequences.¹⁴ They recommended that such distribution participants be permitted to rely on the provisions of Rule 101. Other commenters recommended that any financial services affiliate of an issuer or selling security holder, whether or not it is acting as a distribution participant in connection with the distribution, should have the benefit of the additional exceptions available under Rule 101.

After considering the commenters' views, the Commission has added a proviso to paragraph (a) of Rules 101 and 102, specifying that any affiliated purchaser of an issuer or selling security holder that also is acting as a distribution participant may comply with the provisions of Rule 101, rather than Rule 102, provided that such affiliated purchaser is not itself the issuer or selling security holder.¹⁵ Thus, during a distribution, an underwriter affiliated with the issuer will be able to comply with the provisions of Rule 101. The Commission is making this revision based upon its experience with Rule 10b-6, and the fact that underwriters affiliated with the issuer are often important market participants that are subject to SRO surveillance.

b. Prospective Underwriter

A *prospective underwriter* is defined as a person: who has submitted a bid to an issuer or selling security holder, and knows or is reasonably certain that such bid will be accepted, whether or not the terms and conditions of the underwriting have been agreed upon; or

who has reached, or is reasonably certain to reach, an understanding with an issuer, selling security holder, or managing underwriter that such person will become an underwriter, whether or not the terms and conditions of the underwriting have been agreed upon.¹⁶ The definition differs from the proposal in that the phrase "is reasonably certain" replaces "reasonably expects." Several commenters requested that the proposed definition provide greater certainty as to when a person becomes a prospective underwriter. They believed that, as a practical matter, it may be difficult or even impossible for a broker-dealer to know when it "reasonably expects" to have its bid accepted or to reach an understanding with an issuer. Although the definition as adopted does not provide a bright line test, the practical effect should be to reduce the circumstances in which a broker-dealer will be a prospective underwriter. The definition reflects the Commission's view that there is frequently some point prior to when a bid actually has been accepted, or a broker-dealer has been told that it will be an underwriter, when it is reasonably certain that such person will be an underwriter, and that the incentive to facilitate the distribution is present at that point.

c. Completion of Participation in the Distribution

Under 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, including all other securities of the same class that are acquired in connection with the distribution, and after any stabilization arrangements and trading restrictions in connection with the distribution have been terminated.

The definition contains a proviso 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.¹⁷ This proviso comports with a provision of Rule 10b-6 and is intended to assure that the underwriter's selling efforts in

¹¹ In this release, terms defined in Rule 100 appear in italics when discussed for the first time.

¹² Rule 100 defines distribution as "an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods."

¹³ Many of the terms and concepts discussed with respect to Rule 101 also are relevant to Rule 102, which proscribes activities by issuers and selling security holders and their affiliated purchasers.

¹⁴ See *infra* Section II.C., discussing Rule 102.

¹⁵ The exception for actively-traded securities is not available for securities that are issued by a distribution participant or an affiliate of the distribution participant. See *infra* Sections II.C.2. and II.C.5.

¹⁶ If a broker-dealer has entered into a continuing agreement with an issuer or selling security holder regarding takedowns of securities off a shelf, such agreement typically would make the broker-dealer reasonably certain that it would participate in a distribution off the shelf.

¹⁷ See *Letter regarding Overallotment Options* (November 27, 1996), 1996 SEC No-Act. LEXIS 868.

connection with the distribution have in fact ceased before trading prohibitions are lifted. Consistent with Rule 10b-6 interpretation, if an overallotment option is exercised for an amount of securities that exceeds the net syndicate short position (*i.e.*, taking into account shares purchased in stabilizing or syndicate short covering transactions), the distribution will not be deemed completed and purchases made prior to the exercise of the option would constitute a violation of Regulation M.¹⁸ Any other distribution participant will have completed its participation when its allotment has been distributed.¹⁹ Several commenters asked the Commission to clarify that securities acquired for investment by persons participating in a distribution would be considered to be distributed. Consistent with an interpretation of Rule 10b-6, securities acquired in a distribution for investment purposes by anyone participating in the distribution, or any affiliated purchaser, are considered to be distributed.²⁰

d. Affiliated Purchaser

The Commission proposed to define *affiliated purchaser* for Rules 101 and 102 as: (1) a person acting in concert with a distribution participant, issuer, or selling security holder in connection with the acquisition or distribution of a covered security; (2) an affiliate who controls the purchase of such securities by a distribution participant, issuer, or selling security holder, or whose purchases are controlled by such persons, or whose purchases are under common control with those of such persons; or (3) an affiliate of a distribution participant, issuer, or selling security holder who regularly purchases securities for its own account or for the account of others, or who recommends or exercises investment discretion with respect to the purchase or sale of securities ("financial services affiliates").

The Commission proposed excluding a financial services affiliate of a distribution participant, but not that of an issuer or selling security holder, from the definition if: (1) the affiliate was a separate and distinct organizational entity from, having no officers or

employees in common with, the distribution participant; (2) the affiliate's bids for, purchases of, and inducements to purchase securities in distribution were made in the ordinary course of its business; and (3) the distribution participant maintained and enforced written policies and procedures designed to segregate the flow of information between the distribution participant and its affiliates ("information barriers"), and obtained an annual independent assessment of the operation of its information barriers.

Although commenters generally supported the Commission's efforts to revise the affiliated purchaser definition, several recommended that financial services affiliates of issuers and selling security holders also be excluded from this definition. Moreover, many commenters stated that precluding common officers and employees and requiring that the distribution participant and affiliate be separate and distinct organizational entities would prevent a large number of multi-service financial institutions from relying on this exception. Noting that large financial services providers frequently have at least some officers or employees with overlapping responsibilities, many commenters argued that the presence of common officers or employees should not preclude an affiliate from availing itself of the exclusion where the affiliate's purchases are made in the ordinary course of its business and the distribution participant has maintained and enforces appropriate information barriers.

The Commission is adopting the first two prongs of the definition substantially as proposed.²¹ In response to several commenters' concerns, the Commission has determined to modify the third prong of the definition. As adopted, the exclusion is available to affiliates of distribution participants, issuers, and selling security holders. Moreover, the condition prohibiting common officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel) has been narrowed to preclude commonality only with respect to those officers or employees that

direct, effect, or recommend transactions in securities.²²

A number of commenters argued that information barriers would not deter manipulative activity because general information regarding a distribution is public. The Commission nevertheless is of the view that information barriers can serve to restrict the flow of non-public information that might inappropriately influence an affiliate's transactions in covered securities. For example, appropriate information barriers would prevent the communication of the details of pricing discussions with the issuer and prospective purchasers, or knowledge as to the demand for the offering.

As adopted, the information barrier requirements specify that the distribution participant, issuer, or selling security holder must maintain and enforce written policies and procedures to prevent the flow of information to or from the affiliate that might result in a violation of Rules 101, 102, or 104 of Regulation M,²³ and obtain an annual, independent review of the operation of its information barriers. As noted in the Proposing Release, an internal audit group may perform the review if such group is independent of the distribution participant, issuer, or selling security holder's corporate financing, trading, and advisory departments.²⁴

The Commission has determined to eliminate the requirement that the affiliate be a separate and distinct organizational entity from the distribution participant, issuer, or selling security holder in the sense of requiring a separate legal entity, because such a condition could result in elevating form over substance. Moreover, in response to comments regarding the growth and complexity of multi-service financial institutions, language providing that an "affiliate" may be a separately identifiable department or division of a distribution participant, issuer, or selling security holder has been added to the second and third prongs of the definition. These changes broaden the scope of financial

¹⁸ See Securities Exchange Act Release No. 19565 (March 4, 1983), 48 FR 10628, 10640 ("Release 34-19565").

¹⁹ See *infra* Section II.C.2.a., discussing the definition of completion of participation in the distribution as it relates to issuers and selling security holders.

²⁰ The definition of completion of participation in the distribution codifies the approach taken by the staff in *Letter regarding VLI Corporation*, [1982-1983] Fed. Sec. L. Rep. (CCH) ¶ 77,625 (October 17, 1983) ("VLI Letter").

²¹ None of the commenters objected to the substance of the first two prongs of the proposed definition, although several commenters believed that these provisions would be sufficient to capture any affiliate with both the means and the incentive to manipulate. As adopted, the first prong of the definition remains unchanged, and the only modification to the second prong is the addition of language providing that an "affiliate" may be a separately identifiable department or division of a distribution participant, issuer, or selling security holder.

²² The Commission believes that this modification will resolve substantially commenters' concerns that sharing one or more senior executives with a distribution participant, issuer, or selling security holder would preclude an affiliate from availing itself of the exclusion. For example, the requirement would not preclude common executives charged with risk management, compliance, or general oversight responsibilities.

²³ The Commission notes that this provision does not require the affiliate to maintain and enforce such information barriers.

²⁴ Proposing Release, 61 FR at 17117. Several commenters requested that the proposed exclusion clarify that an internal audit group may perform the review.

services affiliates that may be eligible for the exclusion.

The Commission believes, however, that affiliates should be restricted from engaging in certain types of activities that present the greatest potential for manipulation during the course of a distribution. As adopted, the definition provides that any affiliate that, during the applicable restricted period, acts as a market maker (other than as a specialist in compliance with the rules of a national securities exchange), or engages, as a broker or a dealer, in solicited transactions or proprietary trading activities, in covered securities is an affiliated purchaser. An affiliate (whether an internal unit or a separate legal entity) engaged in these activities is not eligible for the exclusion to the affiliated purchaser definition.²⁵ In contrast, an affiliate acting as an investment company or investment adviser, or in some other non-broker-dealer capacity, would be eligible for the exclusion.²⁶

The Commission believes that these modifications to the definition of affiliated purchaser will resolve many of the commenters' concerns and avoid unnecessary burdens on multi-service financial organizations with affiliates engaged in financial advisory and other services.²⁷

²⁵ This means, for example, that a broker-dealer that does not make a market in a covered security, or that ceases market maker activity in covered securities during the applicable restricted period, would not fall within the definition of affiliated purchaser. Accordingly, an issuer affiliate that engages only in unsolicited brokerage transactions in covered securities would not fall within the definition.

²⁶ For example, a trustee or other pension plan administrator may avail itself of the exclusion, provided such entity satisfies the remaining conditions of the exclusion.

A multi-service financial institution may engage in both investment advisory services and trading activities. To the extent that the institution's investment advisory services are performed by a separately identifiable department, with no officers or employees that direct, effect, or recommend transactions in securities in common with the trading department, then the investment advisory department may avail itself of the exclusion, provided the remaining conditions of the definition are satisfied. If the same individuals provide investment advisory services and engage in trading activities for the institution, however, it would be difficult, if not impossible, to attribute those functions to "separately identifiable" departments. Similarly, where the same individuals direct, effect, or recommend securities transactions for two separately organized affiliates, one providing investment advisory services and the other engaging in solicited activities, such persons could not avail themselves of the exclusion by simply attributing their solicited transactions to their investment advisory role.

²⁷ The variety and complexity of organizational structures means that Regulation M may apply to some affiliates that it may be appropriate to exclude. In such cases, the Commission, through the Division of Market Regulation, will entertain exemption requests.

3. Securities Subject to Rule 101

The Commission proposed applying the trading restrictions of Rule 101 to covered securities, which would include the security that is the subject of a distribution (*subject security*) and *reference securities*. The Commission is adopting the definition of covered security as proposed, but at the suggestion of some commenters has revised the definition of reference security to describe more specifically the situations when the term applies. The term reference security is defined as a security into which a subject security may be converted, exchanged, or exercised, or which, under the terms of the subject security, may in whole or in significant part determine the value of the subject security.

Several commenters supported the proposed definitions. In general, these commenters believed that the proposed coverage of securities represented a significant improvement from the approach under Rule 10b-6, which extended trading restrictions to any security of the "same class and series" as the security being distributed and any "right to purchase" such security.²⁸ One commenter additionally noted that the elimination of the same class and series analysis would ease greatly the task of identifying securities that are subject to trading restrictions during debt offerings. Other commenters indicated uncertainty regarding the applicability of Regulation M to debt offerings and requested clarification on the coverage of debt securities that are "identical in principal features."

The elimination of the same class and series concept will reduce significantly the application of trading restrictions to nonconvertible debt securities that are not rated investment grade.²⁹ Bids for and purchases of outstanding nonconvertible debt securities are not restricted unless the security being purchased is identical in all of its terms to the security being distributed. For example, Rule 101 does not apply to a security if there is a single basis point difference in coupon rates or a single day's difference in maturity dates, as compared to the security in distribution.³⁰ In the rare situations in which Rule 101 will apply to

²⁸ See Proposing Release, text accompanying notes 29 and 30, 61 FR 17114.

²⁹ Nonconvertible debt and certain other securities that are rated investment grade are excluded from Rule 101. See *infra* Section II.B.6.b.

³⁰ In a distribution of equity securities, however, outstanding classes of securities that differ only in voting rights from the distributed security will be deemed to be the same security for purposes of Regulation M.

outstanding debt, the restricted period will generally be five business days.

In addition, derivative securities (*i.e.*, those that derive all or part of their value from a security being distributed) are not subject to the trading prohibition of Rule 101. Thus, for example, bids for or purchases of options, warrants, rights, convertible securities, or equity-linked securities are not restricted during a distribution of the related common stock because, while they derive their value from the security being distributed, they do not by their terms affect the value of the security in distribution. The National Association of Securities Dealers, Inc. ("NASD") expressed concern about permitting bids for and purchases of derivative securities in the case of a distribution of an underlying security, because trading in derivative securities can have a significant impact on the underlying security.³¹ The NASD recommended that the Commission consider limiting the exclusion to those derivative securities that are not likely to present manipulative risk, such as "out-of-the-money" options. The Commission recognizes that derivative securities, even those that are out-of-the-money, can be used to manipulate the price of an underlying security through inducing arbitrage and other transactions involving the underlying security. It is the Commission's intention, however, to focus trading restrictions on those securities that present the greatest manipulative potential. Moreover, any attempt to manipulate a security in distribution by transactions involving derivative securities will continue to be addressed by the general anti-manipulation provisions, including Sections 9(a)(2) and 10(b) of, and Rule 10b-5 under, the Exchange Act.

Regulation M does apply to reference securities, such as common stock underlying an exercisable, exchangeable, or convertible security that is being distributed. The Commission believes that transactions in reference securities can have a direct and substantial effect on the pricing and terms of the security in distribution.

The definition of reference security also encompasses a security underlying an instrument, such as an equity-linked security, that does not give the holder the right to acquire the security, but whose value is or may be derived from such security.³² A security will be a

³¹ See Letter from Mary L. Schapiro, President, NASD Regulation, Inc. and Alfred R. Berkeley, III, President, Nasdaq, to Jonathan G. Katz, Secretary, SEC (July 23, 1996) ("NASD Comment Letter").

³² Rule 10b-6 by its terms did not apply to the underlying security in these circumstances. The Commission believes, however, that Regulation M

reference security only when it, or an index of which it is a component, is referred to in the terms of a subject security. A security of the same or similar issuer will not be deemed a reference security merely because its price is used as a factor in determining the offering price of a security in distribution.

Commenters sought clarification concerning whether an issuer or distribution participant would be permitted to write a put or maintain a "short put" position during a distribution of an underlying security.³³ Transactions in derivative securities, including put options, are not subject to Rule 101 during an offering of the underlying security. In addition, maintaining a short put position is not deemed to be a continuing bid for the underlying security for purposes of Regulation M.

4. Restricted Periods of Rule 101

a. Duration. As discussed below, the Commission is adopting the exclusion from Rule 101 for actively-traded securities.³⁴ This provision removes from Rule 101 securities with an ADTV value of at least \$1 million where the issuer's common equity securities have a public float value of at least \$150 million. For the remaining securities, Rule 101 restricts transactions by distribution participants in covered securities, unless an exception applies, for the following periods:

- in a distribution of a security with an average daily trading volume (ADTV) value of at least \$100,000, whose issuer has outstanding common equity securities having a public float value of at least \$25 million, the restricted period begins on the later of one business day prior to the date on which the subject security's price is determined or the date on which the person becomes a distribution participant, and ends upon that person's completion of participation in the distribution; and
- in a distribution of any other security, the restricted period begins on the later of five business days prior to the date on which the subject security's price is determined or

should apply to a security whenever it has a price relationship to a subject security as a result of the terms of that security.

In some cases, a reference security may have an extremely attenuated relationship to the security in distribution. While the Commission does not believe that a specific percentage test is a workable means to identify these cases, the staff will provide appropriate guidance in response to specific inquiries.

³³ Cf. *Letter regarding The Chicago Board Options Exchange*, [1990-1991] Fed. Sec. L. Rep. (CCH) ¶ 79,665 (February 22, 1991).

³⁴ See *infra* Section II.B.6.a., discussing the actively-traded securities exception, which excludes from Rule 101 securities having an ADTV value of at least \$1 million and whose issuer's common equity securities have a public float value of at least \$150 million.

the date on which the person becomes a distribution participant, and ends upon that person's completion of participation in the distribution.

The Commission proposed that the restricted periods for an offering would begin one or five business days prior to the pricing of the offering, depending upon the security's ADTV value alone.³⁵ In addition, rather than using the date of commencement of offers or sales as a reference, the Commission proposed to determine the restricted period with reference to the date on which the offering is priced. Commenters generally supported shortening the restricted periods, and favored the one and five business days periods keyed off the offering's pricing.

The Commission believes that the ADTV standard is most relevant for determining which securities are more difficult to manipulate. Nevertheless, the use of a trading volume standard alone could skew the application of Rule 101 based on short-term, aberrational increases in trading volume. To prevent this result, the Commission has added a public float component to the test for determining the applicable restricted period.³⁶ The public float component is intended to capture within Rule 101 those securities that experience unusual trading volume relative to their public float value. While the use of a two-part test requires distribution participants to make an additional calculation, the Commission believes that the combination of these components better identifies securities that are more likely to be resistant to manipulation.

Rule 10b-6 contained restrictions that principally applied during a two or nine day "cooling-off period." Many securities that had a two day cooling-off period under Rule 10b-6 will now have a one day restricted period under Regulation M, or will be free from the restrictions of Rule 101 because they are actively-traded securities.³⁷ Even some nine day securities under Rule 10b-6 will now have a one day restricted

period under Regulation M.³⁸ Approximately one-quarter of the securities that qualified for a two day cooling-off period under Rule 10b-6 are now subject to a five day restricted period because of the different criteria used in Regulation M and Rule 10b-6 for distinguishing securities. While the restricted periods under Regulation M are increased for some securities, other provisions of Regulation M, such as Rule 103 (permitting passive market making for all Nasdaq securities), will address liquidity concerns with respect to many of these securities.

b. Calculation of ADTV and Public Float Value.

The ADTV of a covered security is defined on the basis of reported worldwide average daily trading volume during a specified period prior to the filing of the registration statement or prior to the pricing of the offering, depending on the circumstances. Some commenters questioned whether ADTV can be measured uniformly across markets. The NYSE and the Amex requested that the Commission adopt different standards for determining trading volume on auction and dealer markets.³⁹ These exchanges asserted that the Commission's reliance on reported trading volume to determine this exclusion's availability is discriminatory and anti-competitive, because such a standard allegedly favors dealer markets where dealer interpositioning increases volume as compared with auction markets. The Commission does not believe that it is necessary or appropriate to make distinctions based on the type of market on which the security is traded.⁴⁰ The Commission proposed a three-month calendar period for calculating ADTV. The NASD recommended a rolling 60 day period, calculated as of a date within 10 business days prior to pricing, for determining ADTV.⁴¹ Commenters also requested guidance regarding what

³⁵ Proposing Release, 61 FR at 17113.

³⁶ The Commission has determined that using a public float value component alone would not differentiate securities sufficiently with respect to the likelihood of manipulation because of the wide variations in ADTV value for securities with similar public float value.

³⁷ Based on 1995 volume and price data analyzed by the Commission's Office of Economic Analysis ("OEA"), the Commission estimates that 6,156 securities (out of a total of 7,822 securities listed on the New York Stock Exchange, Inc. ("NYSE"), the American Stock Exchange, Inc. ("Amex"), and (Nasdaq) were subject to a two day cooling-off period under Rule 10b-6. Under Regulation M, of those securities approximately 1,901, or 30.9%, are excluded from the rule; 2,693, or 43.7%, are subject to a one day restricted period; and 1,562, or 25.4%, are subject to a five day restricted period.

³⁸ Based on 1995 volume and price data analyzed by OEA, the Commission estimates that 1,666 securities (out of a total of 7,822 NYSE, Amex, and Nasdaq-listed securities) were subject to a nine day cooling-off period under Rule 10b-6. Under Regulation M, of those securities, 11, or 0.7%, are excluded from the rule; 278, or 16.7%, are subject to a one day restricted period; and 1,377, or 82.6%, are subject to a five-day restricted period.

³⁹ Letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC (May 31, 1996); Letter from James F. Duffy, Executive Vice President and General Counsel, Amex, to Jonathan G. Katz, Secretary, SEC (June 25, 1996).

⁴⁰ See *infra* Section IV., discussing in greater detail the anti-competitive concerns raised by the NYSE and the Amex.

⁴¹ See NASD Comment Letter, at p. 3.

information sources may be used to calculate ADTV, and suggested that the Commission designate the types of information that are acceptable for determining ADTV.

The Commission believes that, with the addition of a test based on public float value that will tend to correct for volume aberrations, a 60 day rolling period provides a sufficient length of time to measure the trading volume of a security. Therefore, the rule permits distribution participants to use a two calendar month or a 60 day rolling period. The 60 day rolling period for calculating ADTV must end within 10 calendar days of the filing of a registration statement, or, if there is no registration statement or if the distribution is a shelf distribution, within 10 calendar days of the offering's pricing. The 10 day period will allow distribution participants in any type of distribution sufficient time to conform to the applicable restricted period. The Commission has decided not to designate acceptable information sources for determining ADTV; rather, a distribution participant should have flexibility in determining a security's ADTV value from information that is publicly available, if such participant has a reasonable basis for believing that the information is reliable.⁴² Furthermore, in calculating the dollar value of ADTV, any reasonable and verifiable method may be used. For example, it may be derived from multiplying the number of shares by the price in each trade, or from multiplying each day's total volume of shares by the closing price on that day.

As for public float value, the Commission is adopting a definition that reflects its usage in Form 10-K (*i.e.*, the aggregate amount of common equity securities held by non-affiliates).⁴³ For example, for reporting issuers the public float value should be taken from the

⁴² *Cf.* Securities Exchange Act Release No. 27247 (September 14, 1989), 54 FR 39194, 39197-98 (discussing the standard under Rule 15c2-11 under the Exchange Act, 17 CFR 240.15c2-11, for a broker-dealer to have a reasonable basis that certain information is true and accurate). For instance, a distribution participant may rely on trading volume as reported by an SRO or comparable entity, or any other source believed to be reliable. Electronic information systems that provide information regarding securities in markets around the world could provide an easy means to determine worldwide trading volume in a particular security.

⁴³ 17 CFR 249.310. *See also* Securities Act Release No. 7326 (August 30, 1996), 61 FR 47706 (proposing the expansion of short-form registration to include companies with non-voting common equity). Form 20-F (17 CFR 249.220f), the annual report form used by foreign private issuers under the Exchange Act, does not require disclosure of public float information. Nonetheless, the public float value of such issuer should be determined in the same manner as provided in Form 10-K.

issuer's most recent Form 10-K or based upon more recent information made available by the issuer.

5. Offerings Subject to Rule 101

a. Generally. The provisions of Rule 101 apply in connection with a distribution of securities.⁴⁴ The same types of offerings or other transactions that satisfied the distribution criteria under Rule 10b-6 (*i.e.*, the magnitude of the offering/selling efforts test) also are subject to Rule 101. These include public offerings, private placements, shelf offerings, mergers and other acquisitions, exchange offers, forced conversions of securities, warrant solicitations, and at-the-market offerings.

b. Shelf Offerings. The Commission is modifying its approach to shelf-registered distributions by replacing the "single distribution position" taken under Rule 10b-6.⁴⁵ Under Regulation M, each takedown off a shelf is to be individually examined to determine whether such offering constitutes a distribution (*i.e.*, whether it satisfies the "magnitude" of the offering and "special selling efforts and selling methods" criteria of a distribution). Under prior Commission interpretation, if the aggregate amount of securities registered on a shelf constituted a Rule 10b-6 distribution, each takedown was deemed to be part of that single distribution for purposes of the rule, regardless of its individual magnitude.⁴⁶

The Commission's modified approach means that a broker-dealer participating in a takedown off a shelf must determine whether it is participating in a distribution.⁴⁷ In those situations where a broker-dealer sells shares on behalf of an issuer or selling security holder in ordinary trading transactions into an independent market (*i.e.*, without any special selling efforts) the offering will not be considered a distribution and the broker-dealer will not be subject to Rule 101.⁴⁸ A broker-

⁴⁴ *See supra* Section II.B.1., discussing the definition of distribution.

⁴⁵ *See* Release 34-19565, 48 FR at 10631.

⁴⁶ *See* Proposing Release, 61 FR at 17115, and Release 34-19565, 48 FR at 10631. *See also* Securities Exchange Act Release No. 23611 (September 11, 1986), 51 FR 33242, 33244 ("Release 34-23611").

⁴⁷ An issuer's description in a shelf registration statement of a variety of potential selling methods will not cause, by itself, any sales off the shelf to be treated as a distribution, unless the broker-dealer in fact uses special selling efforts or selling methods in connection with particular sales off the shelf, and the sales are of a magnitude sufficient to demonstrate the existence of a distribution. *Cf.* Securities Exchange Act Release No. 18528 (March 3, 1982), 47 FR 11482, 11485.

⁴⁸ This approach assumes that the broker-dealer is disposing of shares in ordinary trading transactions

dealer likely would be subject to Rule 101, however, if it enters into a sales agency agreement that provides for unusual transaction-based compensation for the sales, even if the securities are sold in ordinary trading transactions.

c. Mergers, Acquisitions, and Exchange Offers. Many commenters questioned the application of Rule 101's restricted periods to mergers, acquisitions, and exchange offers. These commenters noted that during merger distributions subject to Rule 10b-6, trading restrictions were imposed during the applicable two or nine day period prior to the mailing of proxy solicitation materials and for the duration of the proxy solicitation.⁴⁹ Similarly, the Commission also considered the commencement of any valuation period or any election period as the equivalent of the "commencement of offers or sales," requiring bids and purchases to cease during the applicable two or nine day period and for the duration of the valuation or election period.⁵⁰ Several commenters stated that by requiring the restricted period to commence one or five days prior to pricing, it is possible that the restricted period for a merger distribution could begin several months prior to the mailing of the proxy materials. These commenters noted that in such situations the restricted period could be much lengthier under Regulation M, as compared to the practice under Rule 10b-6.

The Commission believes that mergers, acquisitions, and exchange offers involve distributions in which interested persons have considerable incentive to manipulate. The Commission agrees with the commenters that the Regulation M restricted periods should reflect the characteristics of these types of distributions. Accordingly, as adopted the restrictions of Regulation M begin on the day when proxy solicitation or offering materials first are disseminated to security holders and end with the completion of the distribution (*i.e.*, the time of the shareholder vote or the expiration of the exchange offer).⁵¹

into an independent market (*i.e.*, one not dominated or controlled by the broker-dealer, and where the price is not manipulated by the broker-dealer or others acting in concert with the broker-dealer). Release 34-23611, 51 FR at 33247.

⁴⁹ *See* Release 34-19565, 48 FR at 10638-39.

⁵⁰ *Id.* at 10639.

⁵¹ In addition, Rule 10b-13 under the Exchange Act continues to prohibit any purchases or arrangements to purchase securities that are the subject of an exchange offer, or a security immediately convertible into or exchangeable for those securities, from the time of public

Consistent with an interpretation under Rule 10b-6, a restricted period also will apply during any period where the market price of the offered security will be a factor in determining the consideration to be paid pursuant to a merger, acquisition, or exchange offer. Thus, activity proscribed by Rules 101 and 102 must cease one or five business days before the commencement of any valuation period and for the duration of such period.⁵²

d. At-the-market Offerings. In an *at-the-market offering*, sales prices are established during the course of the offering based upon market conditions at the time of individual sales.⁵³ Accordingly, the restricted period for such an offering would commence one or five business days before the pricing of each sale and continue until the person's participation in the distribution is completed. In practice, the application of Rule 101 will essentially be the same as in the case of a fixed price offering, where one price is established for the entire distribution, because the activities of distribution participants are restricted during the entire course of offers and sales, whether the securities are sold at fixed or varying prices.

6. Securities Excepted from Rule 101

a. Exception for Actively-traded Securities. The Commission proposed excluding from Rule 101 all securities with a published ADTV value of at least \$1 million, and requested comment on whether another test, such as a public float test, should be used to determine which securities should be excluded from the rule. Commenters supported an exclusion for actively-traded securities, with two commenters suggesting a lower threshold and one recommending a threshold of \$10 million. The Commission is adopting an exception for those securities that have an ADTV value of at least \$1 million that are issued by an issuer whose common equity securities have a public float value of at least \$150 million.

The Commission continues to believe that an exclusion for actively-traded securities is appropriate. The costs of manipulating such securities generally are high. In addition, because actively-traded securities are widely followed by the investment community, aberrations in price are more likely to be discovered and quickly corrected. Moreover, actively-traded securities are generally

announcement until the expiration of the exchange offer. 17 CFR 240.10b-13.

⁵² Release 34-19565, 48 FR at 10639.

⁵³ The term at-the-market offering is defined as an offering of securities at other than a fixed price.

traded on exchanges or other organized markets with high levels of transparency and surveillance.

The reasons for incorporating a dual ADTV value/public float value test for the restricted periods similarly apply to determining whether securities qualify for the actively-traded securities exception.⁵⁴ The Commission selected \$150 million for the public float value test because it believes that the securities of issuers with a public float value at or above this threshold, and that also have an ADTV value of at least \$1 million, have a sufficient market presence to make them less likely to be manipulated. As discussed above, the \$150 million public float value test is intended in part to exclude issuers from the actively-traded securities exception where a high trading volume level is an aberration.

The combined minimums of \$1 million ADTV value for the securities and \$150 million public float value removes from Rule 101 the equity securities of approximately 1,900 domestic issuers, as well as those of a substantial number of foreign issuers.⁵⁵ The Commission estimates that the addition of a public float test reduces by approximately 9% the number of domestic issuers whose common stock would be excepted from Rule 101 based solely on an ADTV test.⁵⁶

b. Investment Grade Securities. The Commission is adopting an exception to Rule 101 for nonconvertible debt securities, nonconvertible preferred securities, and *asset-backed securities*, provided that the security being distributed is rated investment grade by at least one *nationally recognized statistical rating organization*.⁵⁷ The

⁵⁴ For example, the Commission considered using the \$75 million public float value measure included in the eligibility criteria for Forms S-3 and F-3 under the Securities Act. However, the Commission adopted that threshold for different reasons, *i.e.*, information regarding companies with a public float value of at least \$75 million is efficiently assimilated by the market because they are likely to be followed by multiple analysts. See Securities Act Release No. 7053 (April 19, 1994), 59 FR 21644; Securities Act Release No. 7029 (November 3, 1993), 58 FR 60307. Therefore, it was appropriate to permit incorporation of Exchange Act filings in registration statements filed by such issuers.

⁵⁵ Based on transaction information for 1995 analyzed by OEA, approximately 1,106 securities listed on the NYSE, 770 securities quoted on Nasdaq, and 36 securities listed on the Amex would be excluded from Rule 101. The general increase in security prices and trading volume since year-end 1995 likely will increase the number of securities satisfying the ADTV minimum.

⁵⁶ Based on 1995 volume and price data analyzed by OEA, 2,103 securities have an ADTV value of at least \$1 million; 1,912 securities have an ADTV value of at least \$1 million and a market capitalization of at least \$150 million.

⁵⁷ The term nationally recognized statistical rating organization in paragraph (c)(2) of Rule 101

Proposing Release recommended excepting investment grade nonconvertible debt and preferred securities and noted that the comparable Rule 10b-6 exception was based on the premise that these securities are traded on the basis of their yields and credit ratings, are largely fungible and, therefore, are less likely to be subject to manipulation. The Commission solicited comment on whether investment grade asset-backed securities have the same characteristics with respect to trading as nonconvertible investment grade debt of corporate issuers, and whether such securities should be excepted from the rule.

Several commenters stated that investment grade asset-backed securities should be excepted from Rule 101 because they are the functional equivalent of investment grade debt. One commenter suggested using the definition of asset-backed security contained in the Instruction to Form S-3 for purposes of Rule 101. Another commenter, although not proposing a definition of asset-backed security, recommended an exception for investment grade asset-backed securities backed by a fixed pool of receivables.

Asset-backed securities are excluded from Rule 101 because such securities trade primarily on the basis of yield and credit rating. The principal focus of investors in the asset-backed securities market is on the structure of a class of securities and the nature of the assets pooled to serve as collateral for those securities, rather than the identity of a particular issuer. Investment grade asset-backed securities also are similar to investment grade nonconvertible debt and preferred securities. Therefore, Rule 101 excepts securities that are "primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders"⁵⁸ and that are rated investment grade.

A few commenters also proposed that an even broader exception for debt and preferred securities be adopted, suggesting that high-yield debt securities be excepted from Rule 101 when those securities satisfy certain criteria. One commenter proposed that all debt be excluded from coverage of

has the same meaning as that term is used in 17 CFR 240.15c3-1(c)(2)(vi).

⁵⁸ This definition is identical to the definition of asset-backed security contained in General Instruction I.B.5. to Form S-3, 17 CFR 239.13(b).

Rule 101. The Commission believes that, as a practical matter, Rule 101 and Rule 102 will have very limited impact on debt securities, except for the rare situations where selling efforts continue over a period of time.⁵⁹ In those circumstances, where the incentive to manipulate can escalate, the Commission believes that the application of Regulation M is appropriate.

c. Exempted Securities. The Commission is adopting the proposed exception to Rule 101 for "exempted securities" as defined in Section 3(a)(12) of the Exchange Act.⁶⁰ Transactions in these securities are not restricted by Rule 101. This exception is similar to a provision contained in Rule 10b-6.

d. Face-amount Certificates or Securities Issued by an Open-end Management Investment Company or Unit Investment Trust. The exception to Rule 101 for face-amount certificates issued by a face-amount certificate company, or redeemable securities issued by an open-end management investment company or a unit investment trust, is adopted as proposed. Transactions in these securities are not covered by Rule 101. An identical provision existed in Rule 10b-6.

17. Activities Excepted from Rule 101

a. Exception 1—Research. The Commission is adopting exception 1 to Rule 101, which permits the publication or dissemination of any information, opinion, or recommendation relating to a covered security if the conditions of either Rule 138 or Rule 139 under the Securities Act are satisfied.⁶¹ This exception more closely aligns Rule 101 with the Securities Act rules governing permissible research activities by broker-dealers participating in offerings of securities.⁶²

As proposed, the exception required the research to be published or disseminated "in the ordinary course of business." Several commenters found this phrase to be confusing because Rule 138 requires that research be published or distributed in the "regular course of

business,"⁶³ and Rule 139 requires that information, opinions, or recommendations be contained in a publication that is distributed with "reasonable regularity in the normal course of business."⁶⁴ The Commission has deleted as redundant the phrase "in the ordinary course of business" from exception 1.

Commenters also were uncertain about the application of this exception to electronically disseminated research. The Commission believes that if a distribution participant, in the normal course of its business, provides research reports to independent research services that make such reports available to their subscribers electronically, whether or not the subscribers are customers of or have previously received research from the broker-dealer, such research is excepted from Rule 101.⁶⁵ Similarly, a distribution participant may update its mailing list (*i.e.*, new persons may be added) where it is intended that they receive all future research sent to others on the list, and not just the research related to the security in distribution.

Some commenters inquired whether the exception would be available to unregistered offerings, because Rules 138 and 139 pertain to the dissemination of research during registered offerings. In the Commission's view, for purposes of Rule 101, exception 1 is available during distributions that are not registered under the Securities Act, as long as the conditions of either Rule 138 or Rule 139 are satisfied, other than those pertaining to the filing of a registration statement. A few commenters further recommended that research disseminated outside of the United States during a global offering be excepted from Rule 101's coverage, if such research is disseminated in conformity with local rule or custom. The Commission has determined that the conditions of Rules 138 and 139 (other than registration) define the appropriate parameters for research activities involving securities distributed in the United States because research activities outside the United States in connection with a distribution subject to the rule could be used to facilitate the distribution in the United States. The Commission notes, however, that many of the securities distributed in global offerings will be subject to the rule's actively-traded securities

exception and, therefore, not subject to Rule 101's provisions.⁶⁶

b. Exception 2—Transactions Complying with Certain Other Sections. Exception 2, which allows passive market making transactions and stabilizing transactions complying with Rules 103 or 104, respectively, is adopted as proposed.

c. Exception 3—Odd-Lot Transactions. Exception 3, permitting distribution participants to bid for or purchase odd-lots during the restricted period, is adopted as proposed. Accordingly, a distribution participant may purchase odd-lots during a distribution. Among other things, this exception permits distribution participants to engage in activities in connection with issuer odd-lot tender offers conducted pursuant to Rule 13e-4(h)(5) under the Exchange Act, including effecting purchases necessary to permit odd-lot holders to "round-up" their holdings to 100 shares.

d. Exception 4—Exercises of Securities. Exception 4 permits distribution participants to exercise any option, warrant, right, or any conversion privileges set forth in the instrument governing a security. This exception does not distinguish call options acquired before the person became a distribution participant from those acquired afterwards. In addition, the exception covers exercises of non-standardized call options.

Supporters of this exception noted that option exercises do not involve significant manipulative potential because of the unpredictability of the timing and the extent of purchases by persons writing call options. As noted earlier, the NASD expressed more general concerns about Regulation M's limited coverage of derivative securities.⁶⁷ The Commission believes that exercises or conversions of derivative securities generally have an uncertain and attenuated manipulative potential and, for that reason, has adopted the exception as proposed.⁶⁸

In light of the treatment of derivative securities under Regulation M, the Commission is rescinding Rule 10b-8,

⁵⁹ See *supra* Section II.B.3., discussing covered securities.

⁶⁰ 15 U.S.C. 78c(a)(12).

⁶¹ 17 CFR 230.138, 230.139.

⁶² Exception 1 differs from a previous staff position that certain research reports were not prohibited inducements to purchase if such research was issued by a broker-dealer in the ordinary course of business, and satisfied either Rule 138 or Rule 139(b), or satisfied Rule 139(a) and did not contain a recommendation or earnings forecast more favorable than that previously disseminated by the firm. Securities Exchange Act Release No. 21332 (September 19, 1984), 49 FR 37569, 37572 n.25.

⁶³ 17 CFR 230.138 (a) and (b).

⁶⁴ 17 CFR 230.139(b)(1)(i).

⁶⁵ Also, a broker-dealer may deliver research reports to its customers via electronic means as a substitute for paper delivery. See Securities Exchange Act Release No. 37182 (May 9, 1996), 61 FR 24644.

⁶⁶ Nevertheless, there may be other circumstances in which the dissemination of research that does not meet the conditions of Rules 138 or 139 outside the United States may be appropriate during a global offering. The staff will provide guidance on a case-by-case basis.

⁶⁷ See *supra* text accompanying note 31.

⁶⁸ The Commission cautions that in connection with exercises of non-standardized options and other securities that are privately negotiated between the parties, there may be circumstances when the exercise of a call option, for example, could be made for the purpose of requiring the other party to acquire the security. In such a case, the purchase by the party exercised against may be deemed to be a purchase by the exercising party.

which pertained to distributions through rights. This rule contained overly rigid and complex restrictions on purchases of rights and regulated sales of offered securities. Bids for and purchases of rights are not subject to Rules 101 and 102, although bids for and purchases of a security that is the subject of a rights distribution are restricted by these rules.

e. Exception 5—Unsolicited Transactions. The Commission is adopting an exception to Rule 101 for unsolicited brokerage transactions, and for certain unsolicited purchases as principal. This exception incorporates the provision contained in exception (xi)(D) to Rule 10b-6 for unsolicited principal transactions, and, similar to exception (ii) to Rule 10b-6, permits unsolicited purchases that are not effected from or through a broker or dealer, on a securities exchange, or through an inter-dealer quotation system or *electronic communications network* ("ECN") as defined in Rule 11Ac1-1(a)(8) under the Exchange Act.⁶⁹

This exception places no restrictions on distribution participants effecting unsolicited brokerage transactions during a distribution.⁷⁰ In addition, unsolicited purchases as principal are also unrestricted. Although the Commission did not propose an exception to Rule 101 for unsolicited principal purchases, many commenters asserted that exception (ii) to Rule 10b-6 pertaining to such purchases was, in fact, widely used. The Rule 101 exception for unsolicited purchases differs from the analogous Rule 10b-6 exception, however, because it does not require that purchases be of "block" size.⁷¹

Furthermore, the exception applies to purchases effected otherwise than through a broker-dealer, on a securities exchange, or through an inter-dealer quotation system or ECN, because those purchases are less likely to be used to influence the price of a security that is the subject of a distribution. This clause of the exception permits distribution participants and affiliated purchasers to

purchase covered securities from persons, other than broker-dealers, who were not solicited by the distribution participant or its affiliated purchasers and precludes purchases through an exchange, Nasdaq, or alternative trading system.

This exception reflects the view that unsolicited purchases, regardless of their size, generally do not raise the concerns at which Rule 101 is directed when those purchases are not effected through market mechanisms. In such circumstances, those purchases are less likely to affect the offered security's price.

f. Exception 6—Basket Transactions. Exception 6 relates to purchases of covered securities made in connection with basket transactions. This exception permits transactions in covered securities when the aggregate dollar value of any bids for or purchases of a covered security constitutes 5% or less of the total dollar value of the basket being purchased, and the basket contains at least 20 stocks.

The exception is available with respect to both index-related baskets and customized baskets. To qualify for the exception, the basket transaction must be a *bona fide* transaction effected in the ordinary course of business (*i.e.*, the decision to include the security in distribution in the basket must be independent of the existence of the distribution).⁷² The exception also permits bids and purchases for the purpose of adjusting an existing basket position related to a standardized index when made in the ordinary course of business to the extent necessary to reflect a change in the composition of the index. For example, a basket could be adjusted to reflect substitutions of securities in a standardized index.

While supporting the flexibility of the basket transaction exception, some commenters suggested alternatives, including using either a single percentage test of 5% or 10%, or a 10%/10 stock or 10%/15 stock standard. The Commission believes that the majority of stocks contained in baskets will be excepted under the actively-traded securities exception and that the 5%/20 stock standard allows trading in most basket transactions while ensuring that such transactions are not easily used to influence the price of a security. The Commission is concerned that, given the possibility that a distribution participant could time its basket transactions for maximum price effect, a less rigorous standard could lead to abuse. Further, the inclusion of the 20 stock criterion provides an objective

indication of the *bona fide* nature of the basket transaction.

Commenters also stated that this exception should allow for rebalancing any customized basket covered by the exception, or for rebalancing in a covered security that is consistent with rebalancing activity in other stocks contained in the basket. In the Commission's view, allowing distribution participants to make adjustments in customized baskets may give a distribution participant the means to effect significant transactions in covered securities (*e.g.*, by deciding to include a security in distribution in a basket without a reason independent of the distribution), thereby raising manipulative concerns. Accordingly, the Commission is not permitting adjustments to rebalance customized baskets, unless the adjustments themselves qualify under the 5%/20 stock test.

g. Exception 7—*De Minimis* Transactions. The Commission is adopting exception 7 for *de minimis* transactions. As proposed, the exception applied to unaccepted bids and aggregate purchases of 1% of a security's ADTV. Several commenters stated that a 1% level was too limited to be useful. For this reason, a few commenters proposed raising the *de minimis* threshold to 5% of the security's ADTV. Commenters also requested clarification that the *de minimis* test could be applied to more than one transaction. In addition, some commenters suggested that any bid or purchase not exceeding a *de minimis* amount should be eligible for the exception.

Because the Commission believes that an exception for small, inadvertent transactions lacking market impact is appropriate, it is adopting an exception for *de minimis* transactions. The purchasing level has been increased to 2% to give distribution participants greater margin for error, while retaining the exception's *de minimis* nature. Unaccepted bids, and purchases during the restricted period that in the aggregate do not exceed 2% of the ADTV of the security in distribution, are excepted from the rule, if the person has maintained and enforces written policies and procedures reasonably designed to achieve compliance with the rule. Once inadvertent transaction(s) are discovered, subsequent transaction(s) would not be covered by this exception. Also, this *de minimis* exception does not apply to Nasdaq passive market making transactions.

Commenters recommended that the exception be extended to include solicited brokerage transactions and

⁶⁹ 17 CFR 240.11Ac1-1(a)(8). See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48289 ("Release 34-37619A"), for a discussion of ECNs. A purchase in response to an order or quote displayed on an ECN would not constitute an unsolicited transaction.

⁷⁰ This exception incorporates the provisions of Rule 10b-6(a)(5)(B). In addition, consistent with an interpretation under Rule 10b-6, a broker-dealer who receives an unsolicited order to sell may solicit purchasers in executing the transaction as broker for the seller.

⁷¹ Also, the exception as adopted does not incorporate the phrase "privately negotiated" because it is unnecessary in light of the other terms of the exception.

⁷² Proposing Release, 61 FR at 17118.

bids that are accepted, but that do not result in a purchase because the trade is broken. The Commission clarifies that the exception is available to transactions resulting from solicited brokerage provided that the conditions of the exception are satisfied. However, any purchase, even if the trade subsequently is broken, must be considered a purchase for purposes of this exception.

One commenter asserted that the proviso requiring written policies and procedures is unnecessary. This requirement is adopted as proposed, however, because the Commission believes that the presence of compliance procedures buttresses the inadvertent character of excepted *de minimis* transactions. The Commission notes that repeated reliance on the exception would raise questions about the adequacy and effectiveness of a firm's procedures. Therefore, upon the occurrence of any violation, a broker-dealer is expected to review its policies and procedures and modify them as appropriate.

h. Exception 8—Transactions in Connection with a Distribution. The Commission is adopting the exception for transactions in connection with a distribution substantially as proposed. Exception 8 permits transactions among distribution participants in connection with the distribution and purchases from an issuer or selling security holder in connection with the distribution that are not effected on a securities exchange or through an inter-dealer quotation system, or through an ECN. Based on commenters' views, the portion of the proposed exception relating to offers to sell or the solicitation of offers to buy the securities being distributed or offered as principal is now contained in exception 9.⁷³

i. Exception 9—Offers to Sell or the Solicitation of Offers to Buy. The Commission is adopting the exception for offers 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.

j. Exception 10—Transactions in Rule 144A Securities. The Commission is adopting the exception for transactions in securities eligible for resale under Rule 144A(d)(3) ("Rule 144A securities") substantially as proposed.⁷⁴ As adopted, the exception permits transactions in Rule 144A securities during a distribution of such securities,

provided that sales of such securities within the United States are made solely to: qualified institutional buyers ("QIBs"), or persons reasonably believed to be QIBs, in transactions exempt from registration under the Securities Act ("Rule 144A distributions"); or persons not deemed to be "U.S. persons" for purposes of Rule 902(o)(2) or (o)(7) of Regulation S under the Securities Act, during a concurrent Rule 144A distribution to QIBs.⁷⁵ The exception covers both the Rule 144A security being distributed and any reference security.

In the Proposing Release, the Commission noted that an exception based on the categories of persons to whom the securities are distributed may be viewed as a departure from the anti-manipulation approach of Regulation M, because no class of investors, including large institutions, is immune to injury from securities fraud or manipulation.⁷⁶ Nevertheless, the Commission considers it appropriate to reduce the scope of Rule 101's prophylactic protections in the case of QIBs, because QIBs have considerable ability to obtain, consider, and analyze market information, and the Commission is not aware of complaints of manipulation in this context.⁷⁷ Moreover, in light of the characteristics of Rule 144A securities (e.g., eligible securities are not listed on a U.S. exchange or quoted on Nasdaq), the exception does not distinguish between Rule 144A distributions to QIBs of foreign and domestic securities.⁷⁸

Several commenters recommended broadening the proposed exception to include contemporaneous sales within the United States to certain institutional accredited investors. Some of these commenters suggested that the exception permit sales to institutional accredited investors where sales to QIBs exceeded a certain percentage of the total distribution.⁷⁹ The Commission is not adopting these recommendations because institutional accredited investors encompass a much broader

category of persons, a large segment of which do not have characteristics comparable to those of QIBs which underlie this exception.

8. Exemptive Authority

The Commission proposed to include within Rule 101 a provision permitting the Commission to exempt any transaction or transactions from the rule on a case-by-case basis. Two commenters recommended that the exemptive authority provision be expanded to permit exemptions for securities or classes of securities. To increase flexibility in the exemption process, the Commission is adopting this suggested addition. An exemption may be granted either unconditionally or on specified terms and conditions.⁸⁰

C. Rule 102—Activities by Issuers and Selling Security Holders

1. Generally

Rule 102 covers certain activities of issuers and selling security holders, and their affiliated purchasers, during a distribution of securities. Rule 102 is similar in format to Rule 101: issuers and selling security holders, and their affiliated purchasers, must refrain from bidding for, purchasing, or attempting to induce any person to bid for or purchase a covered security during the applicable restricted period, unless an exception permits the activity.

Rule 102 contains fewer exceptions than Rule 101 because issuers and selling security holders have the greatest interest in an offering's outcome and generally do not have the same market access needs as underwriters. The exceptions in Rule 102 permit: transactions in nonconvertible investment grade securities and transactions during Rule 144A distributions; exercises of options and other securities, including rights; and odd-lot transactions and associated round-up transactions during an issuer odd-lot tender offer. Closed-end investment companies that engage in continuous offerings of securities also may conduct certain tender offers for those securities during such distributions. There is no general exception for actively-traded securities, although a limited exception is included

⁷³ 17 CFR 230.902(o)(2) and (o)(7). This follows the position taken under Rule 10b-6 in *Letter regarding Regulation S Transactions during Distributions of Foreign Securities to Qualified Institutional Buyers*, [1993-1994] Fed. Sec. L. Rep. (CCH) ¶ 76,851 (February 22, 1994), as modified by *Letter regarding Regulation S Transactions during Distributions of Foreign Securities to Qualified Institutional Buyers* (March 9, 1995).

⁷⁴ Proposing Release, 61 FR at 17119 n.61.

⁷⁵ The Commission wishes to emphasize that QIBs will continue to be protected by the general anti-manipulation and anti-fraud provisions, including Section 17(a) of the Securities Act, and Sections 9(a) and 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

⁷⁶ See Proposing Release, 61 FR at 17119.

⁷⁷ The percentages recommended by commenters ranged from 50% to 80%.

⁸⁰ The Commission is revising its Rules of Practice and Investigations to provide that exemptions may be granted by designated persons in the Division of Market Regulation pursuant to authority delegated by the Commission. See 17 CFR 200.30-3 of this chapter, as amended. Rules 102, 104, and 105 include similar provisions authorizing the Commission to grant exemptions from those rules, and this authority also will be delegated to designated persons in the Division of Market Regulation.

⁷³ A distribution participant relying on this exception must be prepared to sell the securities if the offer is accepted.

⁷⁴ See 17 CFR 230.144A(d)(3).

for certain actively-traded reference securities.

Furthermore, most transactions in connection with dividend reinvestment and stock purchase plans are excluded from Rule 102. Only plan distributions involving securities obtained directly from the issuer are subject to Rule 102. Several commenters asked that the Commission further explain the treatment of plans under Rule 102. This release provides guidance on the types of plan activities that may be engaged in without constituting special selling efforts and selling methods within the meaning of the definition of distribution, and clarifies that certain dividend reinvestment and stock purchase plans offered by bank-registered transfer agents and registered broker-dealers qualify for the plan exception.

2. Persons Subject to Rule 102

a. Generally. Rule 102 applies to issuers, selling security holders, and their affiliated purchasers. Several commenters sought clarification as to whether an issuer's transactions in a covered security would be restricted during a distribution effected solely by or on behalf of a selling security holder not affiliated with the issuer. The Commission does not intend to limit an issuer's activities during a distribution effected solely by or on behalf of a selling security holder if the issuer is not an affiliated purchaser of the selling security holder, and has modified paragraph (a) of Rule 102 accordingly.⁸¹ An issuer will be deemed to have completed its participation in a distribution when the entire distribution is completed.⁸²

b. Affiliated Purchaser. As discussed earlier, several commenters recommended excepting financial services affiliates of issuers and selling security holders from the definition of "affiliated purchaser."⁸³ As adopted, the definition of affiliated purchaser excludes financial services affiliates of an issuer or selling security holder if the issuer or selling security holder maintains and enforces information barriers between itself and such affiliates. In addition, a proviso has been added to paragraph (a) of Rule 102 that provides that any affiliated purchaser of

an issuer or selling security holder that is acting as a distribution participant may comply with Rule 101, rather than Rule 102.⁸⁴ This accommodates the ordinary market activities of broker-dealers and other financial institutions participating in a distribution because they are subject to SRO surveillance.

3. Securities Subject to Rule 102

The restrictions of Rule 102 apply to covered securities in the same manner as Rule 101.⁸⁵ Thus, persons subject to Rule 102 are precluded during the restricted period from bidding for or purchasing the subject security or any reference security.

4. Offerings Subject to Rule 102

a. Generally. As with Rule 101, Rule 102 applies only when there is a distribution of securities.⁸⁶

b. Shelf Offerings. In the case of an offering of securities pursuant to a shelf registration statement, the Commission will apply Regulation M in a manner consistent with interpretations under Rule 10b-6 regarding the restrictions on issuers and selling security holders during shelf offerings.⁸⁷ Thus, an issuer and all of its affiliated purchasers are subject to the applicable restricted period of Rule 102 when sales off a shelf by an issuer, or by any affiliated purchaser, constitute a distribution of securities. Similarly, when a selling security holder sells off the shelf and such sales constitute a distribution, all other shelf security holders who are affiliated purchasers of the selling security holder are subject to the applicable restricted period of Rule 102.

5. Securities Excepted from Rule 102

a. Actively-traded Reference Securities. Many commenters maintained that issuers, selling security holders, and their affiliated purchasers should have the benefit of an actively-traded securities exception similar to that in Rule 101. The Commission believes that persons subject to Rule 102 should not be able to trade in their securities, whether or not they are actively traded. The Commission's view is based on issuers' and selling security holders' stake in the proceeds of the offering, and their generally lesser need to engage in securities transactions.

Certain commenters noted that, as proposed, Regulation M would have prevented an issuer of equity-linked securities, or its affiliated purchasers, from engaging in hedging activity in the associated reference security, even when that security was actively traded. According to these commenters, the ability to conduct such hedging activity immediately prior to the pricing of an equity-linked security is critical to the structure of such distributions.

In response to these comments, the Commission has determined to provide a limited exception from Rule 102 for actively-traded reference securities that are not issued by the issuer of the security in distribution, or by any affiliate of the issuer. This exception permits the type of hedging activity that was not previously subject to Rule 10b-6. Thus, the issuer of an equity linked security, or a security holder selling an equity-linked security, can purchase in a hedging transaction an actively-traded reference security issued by an unaffiliated entity. However, the issuer or selling security holder of an equity-linked security is prohibited from purchasing any reference security for which it, or any of its affiliates, is the issuer. Of course, the general anti-fraud and anti-manipulation provisions of the federal securities laws are applicable to any transactions associated with distributions of equity-linked securities.

b. Other Excepted Securities. The Commission is adopting as proposed the exceptions in Rule 102 for "exempted securities" as defined in Section 3(a)(12) of the Exchange Act, and face-amount certificates or securities issued by an open-end management investment company or unit investment trust. In addition, the Commission has determined to include in Rule 102 an exception for investment grade nonconvertible debt, nonconvertible preferred securities, and asset-backed securities, based on commenters' views and the rationales indicated above for an identical exception to Rule 101.⁸⁸

6. Activities Excepted from Rule 102

a. Exception 1—Odd-Lot Transactions. Rule 102 contains an exception for odd-lot transactions, which permits issuer odd-lot tender offers. This exception, which is identical to exception 3 to Rule 101, will provide greater flexibility to issuers conducting odd-lot tender offers during a distribution.⁸⁹ Moreover, as modified from the proposal, this exception permits an issuer conducting an odd-lot tender offer to engage in transactions

⁸¹ The interpretations contained in Release 34-23611 regarding shelf distributions by selling security holders will continue to have relevance. See *infra* Section II.C.4.b.

⁸² Cf. *supra* Section II.B.2.c., discussing when distribution participants are considered to complete their participation in a distribution. See also the definition of "completion of participation in a distribution."

⁸³ See *supra* Section II.B.2.d.

⁸⁴ The proviso to Rule 101 specifies that, where a distribution participant or an affiliated purchaser of a distribution participant is itself the issuer or selling security holder, Rule 102 applies. See *supra* Section II.B.2.a.

⁸⁵ See *supra* Section II.B.3.

⁸⁶ See *supra* Section II.B.5., discussing the types of offerings and other transactions that are subject to Rule 101.

⁸⁷ See Release 34-23611, 51 FR at 33242.

⁸⁸ See *supra* Section II.B.6.c.

⁸⁹ See *supra* Section II.B.7.c.

necessary to enable shareholders to round-up their holdings to 100 shares.⁹⁰

b. Exception 2—Transactions by Closed-end Investment Companies. Exception 2, as it relates to transactions complying with Rule 23c-3 under the Investment Company Act,⁹¹ is adopted as proposed. Accordingly, repurchases by closed-end investment companies that are conducted in compliance with Rule 23c-3 will not violate Rule 102.

Unlike so-called "interval" funds, which buy back their securities pursuant to Rule 23c-3, other closed-end funds are more circumscribed as to their repurchases.⁹² Many of these closed-end funds advise investors in their prospectuses that investments in the funds should be considered illiquid, particularly as the fund does not intend to seek a public trading market for its securities. To provide their investors with an opportunity to sell their securities, these funds often disclose that they may consider conducting periodic tender offers to repurchase all or a portion of their outstanding securities at the then current net asset value. A few commenters raised issues about the continuation of Rule 10b-6 exemptions granted to those closed-end funds that conduct periodic tender offers for their securities pursuant to Rule 13e-4 under the Exchange Act,⁹³ when the funds are engaged in continuous offerings pursuant to Rule 415 under the Securities Act.⁹⁴

Exception 2 is available to a registered closed-end investment company that engages in a continuous offering of its securities pursuant to Rule 415 and repurchases, at net asset value, securities of the same class in a tender offer conducted pursuant to Rule 13e-4, provided that there is no widely available alternative transaction mechanism for its securities (*i.e.*, the securities are not traded on a securities exchange or through an inter-dealer quotation system or ECN). This exception accommodates those closed-end funds that currently have Rule 10b-6 exemptions, and benefits additional closed-end funds with similar distribution and repurchase features,

⁹⁰ Today, the Commission also is adopting an amendment to Rule 13e-4(h)(5) to permit issuers to conduct odd-lot offers, including continuous, periodic, or extended odd-lot offers, for their equity securities without establishing a record date of ownership for shareholder eligibility to participate in the offer. Securities Exchange Act Release No. 38068 (December 20, 1996).

⁹¹ 17 CFR 270.23c-3.

⁹² *Cf.* 15 U.S.C. 80a-23(c).

⁹³ 17 CFR 240.13e-4.

⁹⁴ 17 CFR 230.415. See, e.g., *Letter regarding Brazilian Investment Fund, Inc.*, [1993] Fed. Sec. L. Rep. (CCH) ¶ 76,712 (August 6, 1993).

because they will not need to seek exemptive relief under Regulation M.

c. Exception 3—Redemptions by Commodity Pools or Limited Partnerships. The Commission is incorporating exception 3 to permit redemptions by commodity pools or limited partnerships that are effected at a price based on the securities' net asset value in accordance with the terms and conditions of the governing instruments, as long as the securities are not traded on an exchange, or through an inter-dealer quotation system or ECN. This exception is being adopted in response to commenter concerns, and permits commodity pools and limited partnerships to effect redemptions of their securities without seeking exemptive relief under Regulation M. Redemptions of such securities pursuant to their governing instruments at a price based on net asset value are unlikely to raise manipulative concerns.

d. Exception 4—Exercises of Securities. The Commission is adopting exception 4 relating to the exercises of call options and other securities as proposed. This exception is identical to exception 4 to Rule 101, and permits the exercise of rights in connection with convertible, exchangeable, or exercisable securities, including options received in connection with employee benefit plans.

e. Exception 5—Transactions in Connection with the Distribution. Exception 5 is adopted as proposed. This exception permits offers to sell and the solicitation of offers to buy the securities being distributed, and enables an issuer or selling security holder to conduct an offering on its own behalf.⁹⁵

f. Exception 6—Unsolicited Purchases

In the Proposing Release, the Commission solicited comment on an exception similar to that contained in Rule 10b-6 for unsolicited privately negotiated purchases. This exception from Rule 102 is identical to the unsolicited purchases exception from Rule 101.⁹⁶

g. Exception 7—Transactions in Rule 144A Securities

Based on commenters' views and the basis discussed above for excepting transactions in Rule 144A securities from Rule 101, the Commission has determined to include an identical exception in Rule 102.

⁹⁵ Regulation M does not preclude affiliates of an issuer (*e.g.*, officers or directors) from purchasing securities in the offering. See also *supra* Section II.C.2.a., regarding a person's completion of participation in the distribution.

⁹⁶ See *supra* Section II.B.7.e., discussing exception 5 to Rule 101.

7. Plans

a. Generally

The Commission is adopting the dividend (or interest) reinvestment and stock purchase plan provisions of Rule 102 substantially as proposed.⁹⁷ The treatment of plans under Regulation M reflects a continuation of the Commission's efforts to facilitate the use of plans as an alternative means for investors to purchase and sell securities, while maintaining essential investor protections.⁹⁸

Paragraph (c)(1) of Rule 102 excepts most distributions of securities pursuant to plans.⁹⁹ The Commission has modified the introductory text of this paragraph to clarify that this exception includes plans operated by registered bank transfer agents or registered broker-dealers ("investor services plans"), as well as those plans operated by or on behalf of an issuer.¹⁰⁰

The rule divides plans into three categories: (1) plans that are available only to employees and shareholders ("employee-shareholder plans"); (2) plans, including investor services plans, that are available to persons other than, or in addition to, employees and shareholders, where securities for the plan are purchased from a source other than the issuer or an affiliated purchaser of the issuer (*i.e.*, in the open market or in privately negotiated transactions) by an agent independent of the issuer ("open market plans"); and (3) plans that are available to persons other than, or in addition to, employees and shareholders where securities for the

⁹⁷ The term *plan* is defined in Rule 100 as any bonus, profit-sharing, pension, retirement, thrift, savings, incentive, stock purchase, stock option, stock ownership, stock appreciation, dividend reinvestment, or similar plan; or any dividend or interest reinvestment plan or employee benefit plan as defined in 17 CFR 230.405.

⁹⁸ See, e.g., Securities Exchange Act Release No. 35041 (December 1, 1994), 59 FR 63393 ("1994 STA Letter"), as modified by *Letter regarding Dividend Reinvestment and Stock Purchase Plans*, [1995] Fed. Sec. L. Rep. (CCH) ¶ 77,110 (May 12, 1995); *Letter regarding First Chicago Trust Company of New York*, [1994] Fed. Sec. L. Rep. (CCH) ¶ 76,939 (December 1, 1994) ("First Chicago Letter"); *Letter regarding Bank-Sponsored Investor Services Programs*, [1995] Fed. Sec. L. Rep. (CCH) ¶ 77,122 (September 14, 1995) ("Bank Sponsored Programs Letter") (collectively, "Plan Letters").

⁹⁹ Of course, where an issuer plan does not involve a distribution (because there is insufficient magnitude, or because special selling efforts and selling methods are not used to sell the securities), Rules 101 and 102 do not apply.

¹⁰⁰ Although Regulation M supersedes the Plan Letters as they relate to Rule 10b-6, the staff positions taken in the Plan Letters on the application of other securities law provisions (*i.e.*, Section 5 of the Securities Act, 15 U.S.C. 77e, and Sections 13(e), 14(d), 14(e), 15(a), and 17A of, and Rule 10b-13 under, the Exchange Act, 15 U.S.C. 78m(e), 78n(d), 78n(e), and 17 CFR 240.10b-13, respectively) remain in effect.

plan are purchased directly from the issuer or an affiliated purchaser of the issuer ("direct issuance plans").

b. Employee-shareholder Plans

Rule 102(c)(1)(i) covers employee-shareholder plans, and excludes any distribution pursuant to a plan by or on behalf of an issuer or a subsidiary of an issuer, when the distribution is made solely to *employees* or shareholders of the issuer or its subsidiaries, or to a trustee or other person acquiring the securities for the accounts of such persons. This means that Rule 102 imposes no restrictions on transactions in the subject securities by the issuer or its affiliated purchasers during employee-shareholder plan distributions.¹⁰¹ The scope of eligible employees, and therefore the scope of the exception, is broader under this provision than under Rule 10b-6.

c. Open Market Plans

Rule 102(c)(1)(ii) excepts from the rule's coverage distributions involving open market plans, including investor services plans, where purchases for the plan are made by an *agent independent of the issuer* from sources other than the issuer or an affiliated purchaser of the issuer (*i.e.*, in the open market or in privately negotiated transactions).

Several commenters suggested revising the definition of agent independent of the issuer, including permitting the issuer to specify the broker or dealer who would make purchases for the plan and to change the source of securities for its plan more than once in any three month period. The Commission has determined not to make such changes at this time, because the definition has implications beyond Regulation M (*i.e.*, it also relates to issuer repurchase programs conducted pursuant to Rule 10b-18 under the Exchange Act).¹⁰² Nevertheless, the Commission will examine this definition in connection with its anticipated review of Rule 10b-18, and will reconsider these comments in that process.

The definition of agent independent of the issuer specifies, among other things, that an issuer may not control, directly or indirectly, the timing of purchases by the agent. The Proposing Release stated that an agent would not be considered independent if the issuer directs the timing of purchases of

securities by the agent, including a requirement that securities to fund the plan must be purchased on the plan's investment date. The release provided, however, that an issuer may establish general conditions for the operation of its plan, including, for example, requirements concerning the return of uninvested funds to plan participants, or requirements that optional cash payments be invested within 35 days of receipt.¹⁰³ A number of commenters requested additional guidance on the timing element for plan purchases. The Commission notes that, although an issuer may not specify a particular time for such purchases, the issuer may specify a range of days for plan purchases based on a particular event (*e.g.*, that plan purchases will be made within five days of the plan's investment date, or the stock's dividend date), or may specify that plan purchases will be made on or as soon as practicable after the plan's investment date, or the stock's dividend date. Moreover, the plan's agent could be deemed an agent independent of the issuer for purposes of Rule 102 if the plan's formula specifies the date, but not the times, of purchases pursuant to the plan, provided that the plan provisions regarding the purchase date are not changed more than once in any three-month period.¹⁰⁴

d. Direct Issuance Plans

Distributions pursuant to direct issuance plans (*i.e.*, a plan that is available to persons other than, or in addition to, employees and shareholders where the issuer or affiliated purchaser of the issuer provides the shares for the plan) are not excepted from Rule 102. In the Commission's view, if the magnitude of securities offered through such plan, and the selling efforts and selling methods used to distribute such securities would constitute a distribution as defined in Rule 100, this type of offering raises the manipulative concerns underlying Regulation M.¹⁰⁵ Because the issuer is receiving the

proceeds of the offering, this kind of plan bears a close resemblance to a public offering. Consistent with prior interpretations concerning valuation periods for plans, Rule 102 applies during any valuation period for a direct issuance plan.

To determine the magnitude of a direct issuance plan, only those persons to whom plan communications are directed at a particular time (rather than all current plan participants) should be considered. Moreover, the Commission will not deem special selling efforts and selling methods to be present in a direct issuance plan where only one or a combination of announcements, newspaper advertisements, circulars, notices, investor fairs, or Internet home pages are used to disseminate information about the availability of the plan to the public, or the issuer provides information about the plan to persons with whom the issuer has a pre-existing, continuing relationship involving the receipt of written communications by existing means of communication (*e.g.*, a bill, annual report, or payroll stub).¹⁰⁶ The information contained in such materials distributed by an issuer or its agent may include no more than the information allowed, nor less than that required, under Rule 134 under the Securities Act (*i.e.*, "tombstone advertisements"): ¹⁰⁷ generally, the issuer's name, the issuer's type of business, the type of security being offered in the direct issuance plan (*i.e.*, common or preferred stock), the price of the security or the method of price determination, and information on how and where a prospectus may be obtained.

8. Exemptive Authority

Consistent with the expansion of the exemptive authority provision in Rule 101, the Commission is adopting a provision in Rule 102 pursuant to which it may grant an exemption from Rule 102 to any transaction or class of transactions, or any security or class of securities. Such exemptions may be granted either unconditionally or on specified terms and conditions.

9. Rule 10b-18

Rule 10b-18 under the Exchange Act provides that an issuer and its affiliated

¹⁰⁶ This includes communications to shareholders, employees, customers, and other persons with a pre-existing relationship with the issuer, such as independent contractors, franchisees, and suppliers. See Securities Exchange Act Release No. 37182 (May 15, 1996), 61 FR 24644, 24650 (providing guidance for use of electronic media for delivery of information). See also Securities Exchange Act Release No. 36345 (October 13, 1995), 60 FR 53458.

¹⁰⁷ 17 CFR 230.134.

¹⁰¹ However, such activity may be subject to Rule 102 if the issuer is engaged in another distribution, and the transactions for the plan are attributable to the issuer. Rule 102 provides that plan transactions will not be attributable to the issuer if they are effected by an agent independent of the issuer.

¹⁰² 17 CFR 240.10b-18.

¹⁰³ Proposing Release, 61 FR at 17121 n.71, citing 1994 STA Letter (modifying *Letter regarding Lucky Stores, Inc.*, [1974-1975] Fed. Sec. L. Rep. (CCH) ¶79,903 (June 5, 1974)).

¹⁰⁴ Purchases by an independent agent for a plan can involve a certain magnitude, frequency, and duration that are known to the issuer. If an issuer schedules a non-plan distribution to coincide with such plan purchases, questions may be raised under the general anti-fraud and anti-manipulation provisions of the federal securities laws.

¹⁰⁵ Where a plan provides that securities for the plan may be purchased either in the open market or provided directly by the issuer, paragraph (c)(1)(ii) is only available when the plan securities are purchased in the open market. If the plan securities are obtained directly from the issuer, the plan must be treated as a direct issuance plan.

purchasers will not incur liability under the anti-manipulation provisions of Section 9(a)(2) of the Exchange Act or Rule 10b-5 under the Exchange Act, if the issuer purchases common stock in compliance with the rule's conditions concerning the time, price, volume, and manner of purchases.¹⁰⁸ The Commission proposed to amend Rule 10b-18 to preclude an issuer from relying on this safe harbor when the issuer or its affiliated purchasers were engaged in a distribution for purposes of Rule 102.

The few comments received on this proposal were negative. The Commission has determined that significant revisions to Rule 10b-18 should be considered in connection with a comprehensive review of Rule 10b-18 to be conducted in the near future. However, the Commission is adopting an amendment to Rule 10b-18 precluding reliance on the safe harbor during the Rule 102 restricted period, when the issuer or any affiliated purchaser is distributing the issuer's common stock or any other security for which the common stock is a reference security.¹⁰⁹

D. Rule 103—Passive Market Making

The Commission is adopting Rule 103 to replace Rule 10b-6A. Rule 103 and related exception 2 to Rule 101 permit, in connection with a distribution of a Nasdaq security, passive market making on Nasdaq during the restricted period of Rule 101, when market making by distribution participants otherwise is prohibited. The purpose of Rule 103 is to alleviate special liquidity problems that could exist for a Nasdaq security in distribution, if distribution participants or their affiliates who are Nasdaq market makers were required to withdraw as market makers during the restricted period. Exchange-traded securities usually do not experience this problem because specialists in most cases are not affiliated with distribution participants.

Rule 103 retains the core provisions of Rule 10b-6A with respect to the price levels of bids and purchases that can be made by a Nasdaq *passive market maker*. Rule 103 generally limits a passive market maker's bids and purchases to the highest current *independent bid* (i.e., a bid of a Nasdaq

market maker who is not participating in the distribution). The Commission believes that this condition is fundamental to the concept of passive market making. Additionally, the rule limits the amount of *net purchases* that a passive market maker can make on any day to 30% of its ADTV, although an initial ADTV limit of 200 shares is now available for less active market makers. The *30% ADTV limitation* is designed to prevent an amount of purchasing activity that could produce the price effects of stabilization, while generally permitting a level of activity associated with normal market making. The rule also contains a provision limiting the bid size a passive market maker may display and requirements relating to notification, identification, and disclosure of passive market making.

Rule 103 incorporates several new provisions that add significant flexibility to passive market making and permit this activity in a far greater number of contexts. The rule eliminates the offering eligibility criteria that were contained in Rule 10b-6A, except that best efforts and at-the-market offerings remain ineligible for passive market making.¹¹⁰ Moreover, all Nasdaq securities qualify for passive market making, including Nasdaq reference securities. The requirement that underwriters or prospective underwriters account for at least 30% of total trading volume is eliminated because the Commission believes that passive market making could enhance liquidity, even where the syndicate accounts for a minor portion of normal market making activity. Rule 103 also permits passive market making throughout the entire applicable restricted period, rather than requiring that it cease with the commencement of offers or sales, because passive market making is now available for many more kinds of distributions, including those that can extend over a significant period of time. Passive market making is prohibited, however, when a stabilizing bid pursuant to Rule 104 is in effect.

The NASD and other commenters proposed either eliminating the 30% ADTV limitation entirely, or, alternatively, increasing it to at least 50%. Commenters did not provide any empirical evidence or other objective

information supporting a different standard or demonstrating that the 30% ADTV limitation significantly decreases the liquidity of securities subject to passive market making. As with Rule 10b-6A, the 30% ADTV limitation is applicable only to *net purchases* (i.e., total purchases minus total sales). Accordingly, as long as sufficient sales are made, there is no limit on total purchases. The Commission continues to believe that a purchasing limitation is fundamental to the concept of passive market making, and that the 30% ADTV limitation permits a normal level of market making activity. In addition, the Commission believes that the adjustment discussed below allowing all passive market makers to have an initial ADTV limit of at least 200 shares will enable less active market makers to participate in passive market making. Of even greater significance is the fact that actively-traded Nasdaq securities are not subject to the requirements of Rule 103 at all, and nearly all other Nasdaq securities will have shorter restricted periods. These features of Regulation M should substantially enhance liquidity for these securities.

As proposed, passive market makers would have been allowed to bid for one round lot (i.e., 100 shares) if they had an initial or remaining net purchasing capacity of between one and 99 shares. This provision was intended to permit less active or smaller market makers who are syndicate members to be passive market makers. The NASD supported providing passive market makers with the ability to bid for and purchase at least 1,000 shares, irrespective of a lower ADTV limitation. The NASD argued that the ADTV limitations of many market makers are too small to make passive market making viable for them. The Commission believes that giving all passive market makers an ADTV limit of 1,000 shares largely would override the 30% ADTV limitation and unduly advantage market makers with historically small trading volumes in the security, who would be able to make net purchases several times larger than their routine market making activity. As adopted, Rule 103 provides that all passive market makers whose initial ADTV limit is between 1 and 199 shares are allowed a net purchasing capacity of 200 shares. Rule 103 also permits bids for a round lot if a passive market maker's remaining net purchasing capacity is between 1 and 99 shares.¹¹¹

¹¹¹ For example, a passive market maker whose 30% ADTV limitation is 743 shares and who made net purchases of 700 shares can still bid for 100 shares.

¹⁰⁸ 17 CFR 240.10b-18.

¹⁰⁹ To reflect the use in Rule 10b-18 of the Regulation M definition of plan, the Commission is adopting technical amendments to paragraphs (a)(3), (a)(5), and (a)(6) of Rule 10b-18 to change the term "issuer plan" to "plan." In addition, the term agent independent of the issuer for purposes of Rule 10b-18 is now defined in Rule 100 of Regulation M. This differs from the proposal which would have removed the safe harbor during the entire distribution period.

¹¹⁰ The Commission previously noted that the NASD surveillance system, with respect to passive market making, does not easily accommodate at-the-market offerings. Securities Exchange Act Release No. 32117 (April 14, 1993), 58 FR 19598, 19600 ("Release 34-32117"). The Commission believes that NASD surveillance is an essential consideration in expanding the contexts in which passive market making is permitted.

Rule 103 allows passive market makers to make bids or purchases at a price above the highest independent bid where necessary to comply with any Commission or NASD rule relating to the execution of customer orders. For example, a passive market maker acting in accordance with the new Commission rules regarding order handling obligations is permitted to display customer bids and to execute customer orders in compliance with the new rules even if the transactions would otherwise violate Rule 103.¹¹² In addition, the Commission is retaining its interpretation regarding the application of passive market making in the context of NASD members' obligation not to trade ahead of customer limit orders. When a passive market maker is complying with Commission or NASD rules governing the handling of customer limit orders, it cannot initiate any transaction on the sell-side of the market that would create, directly or indirectly, an obligation to purchase a covered security at a price above that security's highest independent bid price.¹¹³

The NASD supported permitting the execution of riskless principal purchases (other than bids disseminated on Nasdaq) at a price higher than Rule 103 allows, as long as the passive market maker does not thereafter adjust its bids above the prevailing highest independent bid. The Commission believes, however, that market maker purchases above the highest independent bid (except as specifically permitted) are not consistent with the rule's passive structure.¹¹⁴

In response to the NASD's comment, the Commission is retaining a modified version of the interpretation regarding contemporaneous transactions, which provides that if a passive market maker is involved in a contemporaneous purchase and sale of a security, the passive market maker can "net" the transactions for purposes of the ADTV calculation as long as the two transactions are reported within 30 seconds of each other.¹¹⁵

¹¹² See Release 34-37619A, 61 FR 48289.

¹¹³ See *NASD Manual*, Conduct Rules, IM-2110-2.

¹¹⁴ Rule 103 permits a passive market maker to continue to bid and effect purchases at its bid at a price exceeding the then highest independent bid until the passive market maker purchases an aggregate amount of the covered security that equals or, through the purchase of all securities that are part a single order, exceeds the lesser of two times the minimum quotation size for the security, as determined by NASD rules, or the passive market maker's remaining purchasing capacity under paragraph (b)(2) of Rule 103.

¹¹⁵ See Release 34-32117, 58 FR at 19603. The Commission also is retaining the interpretations in

The NASD also requested that the *de minimis* exception in Rule 101 apply to passive market making transactions. The Commission believes that permitting passive market makers to have the benefit of the *de minimis* exception would undermine efforts to achieve more rigorous compliance with passive market making restrictions. Therefore, the *de minimis* exception in Rule 101 does not apply to unaccepted bids or to purchases made by a passive market maker.

E. Rule 104—Stabilization and Other Syndicate Activities

1. Generally

Rule 104, which replaces Rule 10b-7, governs stabilizing and certain aftermarket syndicate activities in connection with an offering, and makes it unlawful for any person to stabilize, to effect any syndicate covering transaction, or to impose a penalty bid in contravention of the rule's provisions.¹¹⁶ Rule 104 improves the regulation of stabilization by creating a more flexible framework for managing the offering process and eliminating much of the complexity that characterized Rule 10b-7. The Commission is adopting Rule 104 substantially as proposed, but has added provisions to address issues raised by commenters and has clarified other provisions. Related amendments to Exchange Act Rule 17a-2, governing the recordkeeping of stabilizing and certain post-offering syndicate transactions, and to Items 502(d) and 508 of Regulations S-B and S-K, governing prospectus disclosure of these activities, are adopted as proposed.

The purpose of Rule 104 is to permit underwriters and syndicate members to conduct stabilizing transactions in compliance with the rule's pricing and other terms for the purpose of preventing or retarding a decline in the market price of a security to facilitate an offering. Although stabilization is price-influencing activity intended to induce others to purchase the offered security, when appropriately regulated it is an effective mechanism for fostering an orderly distribution of securities and promotes the interests of shareholders,

the Rule 10b-6A adopting release discussing appropriate interaction with other market makers and permitting the offset of two customer orders received within 15 minutes of each other without affecting net purchasing capacity. Release 34-32117, 58 FR at 19602-03.

¹¹⁶ Unlike Rules 101 and 102, which apply to a "distribution," Rule 104 governs stabilizing to facilitate an "offering," a term that is broader in scope. Moreover, there is no exception to Rule 104 for actively-traded securities.

underwriters, and issuers.¹¹⁷ The rule addresses the risk that stabilization will create a false or misleading appearance with respect to the trading market for the offered security.¹¹⁸

Rule 104 introduces several major features that are different from Rule 10b-7: a stabilizing bid may be made with reference to the principal market for the security, wherever located (rather than focusing only on U.S. markets); a stabilizing bid may be raised to match independent bids in the market; and a stabilizing bid that has not been discontinued may be carried over to another market. Rule 104 also accommodates multinational offerings by permitting stabilizing bids to be made in the currency of the market where the bid is placed, and by allowing adjustments to such stabilizing bids to account for fluctuations in the exchange rates between currencies.

Overall, commenters supported efforts to update and simplify the Commission's stabilization rule. Commenters favored the new provisions governing price levels for stabilizing bids, which codify and expand exemptive and no-action relief issued within the last decade by the Commission and its staff for stabilizing activities involving cross-border offerings. Some commenters were critical of the new provisions requiring disclosure, notification, and recordkeeping of syndicate covering transactions and penalty bids. The Commission, however, believes that these offering-related activities can influence aftermarket prices, and has adopted the provisions as an appropriate method to monitor these activities.

2. Discussion of Provisions Relating to Stabilization

As adopted, Rule 104 provides that no person, directly or indirectly, may stabilize, effect any syndicate covering transaction, or impose a penalty bid in connection with an offering of any security in contravention of the rule's provisions. The term *stabilizing* is defined in Rule 100 as the placing of any bid, or the effecting of any purchase, for the purpose of pegging, fixing, or otherwise maintaining the price of a security. Rule 104 prohibits bids or purchases not necessary to prevent or retard a decline in the security's price, and forbids stabilizing

¹¹⁷ See Section 9(a)(6) of the Exchange Act, 15 U.S.C. 78i(a)(6); Concept Release, 59 FR at 21689. See also Securities Exchange Act Release No. 2446 (March 18, 1940), 11 FR 10971.

¹¹⁸ See Securities Exchange Act Release No. 28732 (January 8, 1991), 59 FR 814, 815 ("Release 34-28732").

for manipulative purposes, at a price resulting from unlawful activity, or in an at-the-market offering. Priority must be granted to independent bids regardless of the size of the independent bid, when the market where the stabilizing takes place permits or requires such priority. The placing of more than one stabilizing bid in any one market at the same price at the same time is prohibited. The Commission is adopting these provisions substantially as proposed.

Rule 104 excludes from its provisions offerings of securities eligible for resale under Rule 144A by foreign or domestic issuers made solely to QIBs in transactions exempt under the Securities Act and to non-U.S. persons under Regulation S that are made concurrently with a Rule 144A offering.¹¹⁹ As with other transactions excluded from Regulations M's coverage, stabilization during these Rule 144A placements will remain subject to the general anti-fraud and anti-manipulation provisions of the federal securities laws.

The provision in Rule 10b-7(m) pertaining to limitation of liability is eliminated. Although one commenter favored retention of this provision, the Commission believes that because lead managers now exert considerably more control over stabilizing transactions than when Rule 10b-7 was adopted, the provision is of marginal utility.

3. Stabilizing Levels

Rule 104 provides considerable flexibility to underwriters effecting stabilizing transactions. Persons stabilizing the price of a security can initiate a stabilizing bid in any market with reference to the independent prices in the *principal market* for the security, wherever located, and then maintain, reduce, or raise that bid to follow the independent market, as long as the bid does not exceed either the stabilizing bid in the principal market (including a stabilizing bid in effect at the previous close) or the *offering price* of the security.¹²⁰ Commenters favored using the price in the security's principal market as a basis for initiating a stabilizing bid when that market was open. One commenter also advocated the ability to carry over a stabilizing bid from one market to another market, irrespective of the current independent prices in any market.

Under Rule 104, the appropriate price level for initiating stabilizing is based

¹¹⁹ Identical exceptions are contained in Rules 101 and 102 of Regulation M.

¹²⁰ The term offering price is defined in Rule 100 as the price at which the security is being distributed.

on the security's principal market.¹²¹ Although the rule as proposed looked to independent bids in the principal market to establish the permissible stabilizing level, the final version of Rule 104 permits a stabilizing bid to reference the last independent transaction price in the principal market. This modification responds to a commenter's concern that the public offering price of an exchange-traded security frequently is set at the last transaction price and, under Rule 10b-7, the security could be stabilized at that price. The rule covers the two possible scenarios for initiating stabilizing: initiating stabilizing in any market when the principal market is open; and initiating stabilizing in any market when the principal market is closed.

When the principal market is open, the permissible stabilizing price level in any market always is established with reference to the last independent transaction price for the security in its principal market if two conditions are met: the security must have been traded in the principal market on the day stabilizing is initiated or on the preceding business day; and the current asked price in the principal market must be equal to or greater than the last independent transaction price. If both conditions are not satisfied, stabilizing may be initiated in any market at a price no higher than the highest current independent bid in the principal market.

When the principal market is closed, but quotations have opened in the market where stabilizing will be initiated, Rule 104 provides that stabilization may be initiated with reference to the lower of: the price at which stabilizing could have been initiated in the principal market at its previous close; or the last independent transaction price in the market where stabilizing is being initiated. The independent transaction must have occurred that day or on the preceding business day and the current asked price in that market must be equal to or greater than the independent transaction price. If these conditions are not met, stabilizing may only begin at a price no higher than the highest current independent bid for the security in the market where the stabilizing is being initiated.

¹²¹ Rule 104, as adopted, uses the term "initiate," rather than the term "effect," to clarify that "initiating" a stabilizing bid means the first stabilizing bid made in connection with the offering. Once a stabilizing bid has been initiated, it may be increased, maintained, reduced, or adjusted in accordance with the provisions of the rule.

Rule 104 also includes a new provision for initiating a stabilizing bid in any market immediately before the opening of quotations. In this case, stabilizing may be initiated with reference to the lower of: the price at which stabilizing could have been initiated in the principal market at its previous close; or the most recent price at which an independent transaction in the offered security has been effected in any market after the close of the principal market, if the person stabilizing knows or has reason to know of such transaction.¹²²

Rule 104 includes maximum caps on the stabilizing price level: no stabilizing bid may be initiated, maintained, or otherwise adjusted in any market at a price higher than the stabilizing bid in the principal market or the security's offering price.

Once a stabilizing bid has been initiated in a market, that bid may be maintained in that market, subject only to the maximum caps. It also may be carried over into another market, irrespective of intervening changes in the independent bids or transaction prices for the security. A stabilizing bid in effect at the market's close may be maintained between trading sessions and used to establish a stabilizing bid just prior to the market's opening of quotations on the next day.¹²³ A stabilizing bid may be maintained without reduction unless it would exceed the maximum caps. An underwriter may otherwise reduce a stabilizing bid at its discretion. If a stabilizing bid is discontinued (*i.e.*, it is not maintained continuously during a trading session or is not in effect as of the market's close), stabilizing may be resumed only at a level at which it then could be initiated in the particular market, without reference to the earlier stabilizing bid.

In perhaps the most significant change from Rule 10b-7, Rule 104 allows a stabilizing bid to be increased to the level of the highest independent bid in the principal market, or, if the principal market is closed, the highest independent bid in that market at the

¹²² As proposed, the reference price for initiating a stabilizing bid in any market, including the principal market, immediately before it opened was the lower of: the price at which stabilizing could have been effected at the close of the principal market; or the most current reported price at which independent transactions in the offered security have been effected in any market after the close of the principal market. Rule 104 incorporates a knowledge-based standard to avoid imposition of an undue burden on underwriters to discover the prices of obscure transactions, whether reported or not.

¹²³ The end of a trading session will not be deemed to discontinue a stabilizing bid in effect at the close.

previous close, provided such bid price does not exceed the maximum caps.

Where an independent market for an offered security does not exist, the maximum stabilizing level is limited only by the offering price. Stabilization may be conducted before an offering is priced, consistent with the conditions of Rule 104. After the offering price is determined, stabilization may be resumed at a price at which stabilizing then could be initiated.

Rule 104 also provides for adjustments to a stabilizing bid when the price of the security being stabilized is adjusted for the payment of dividends, rights, or distributions, or is expressed in a currency other than the currency of the principal market and there are changes in the exchange rate between the two currencies. When securities are being offered as a unit, the component securities shall not be stabilized at prices that, in the aggregate, are higher than the then permissible stabilizing price for the unit.

4. Offerings With No U.S. Stabilizing Activities

To further accommodate cross-border transactions, the Commission is incorporating a new provision, similar to one contained in its 1991 proposing release on stabilizing in the international context,¹²⁴ that permits stabilizing outside the United States during an offering in the United States, without complying with Rule 104. The conditions for this provision are that: there be no stabilization in the United States; stabilization is not conducted above the U.S. offering price; and the foreign stabilizing is conducted in a jurisdiction with comparable regulation of stabilization.¹²⁵ For purposes of this provision, the Commission recognizes the stabilization regulations of the U.K. Securities and Investments Board.¹²⁶ The Commission invites appropriate requests to recognize additional markets as having comparable stabilization regulations for the purposes of this provision.

5. Disclosure, Notification, and Recordkeeping of Stabilizing Transactions, Short Covering Transactions, and Penalty Bids

In the Proposing Release, the Commission expressed its view that syndicate short covering transactions

¹²⁴ Release 34-28732. The proposals contained in Release 34-28732 are withdrawn, except to the extent they are adopted in Rule 104.

¹²⁵ The Commission by rule, regulation, or order will identify foreign statutes or regulations that are comparable to Rule 104.

¹²⁶ Chapter III, Part 10 of the Rules of the United Kingdom Securities and Investments Board.

and the imposition of penalty bids by underwriters are activities that can facilitate an offering in a manner similar to stabilization. The Commission did not propose to extend the price conditions of Rule 104 to these aftermarket activities. Instead, the Commission proposed, and has determined to adopt, the provisions relating to disclosure, notification, and recordkeeping of syndicate covering transactions and the imposition of penalty bids.

Rule 104, like Rule 10b-7, requires any person who enters a bid that such person knows is for the purpose of stabilizing the price of any security to notify the market on which the bid is placed, and to disclose the purpose of such bid to the person to whom the bid is entered (e.g., the specialist or executing broker-dealer). In the Commission's view, contemporaneous disclosure of the fact that stabilizing is occurring is beneficial to the market and its participants, because it ensures that transactions in a security are based on all available information. Consistent with this requirement, the NASD requires market makers intending to initiate stabilization to provide it with prior notification.¹²⁷ Stabilizing bids are then identified by a symbol on the Nasdaq quotation display. In this way, the person engaged in stabilization satisfies the requirement to inform the market and the person to whom the bid is made of the stabilizing purpose of the bid by notifying the NASD. On the exchanges, underwriters must notify the exchange and must provide disclosure separately to the recipient of the bid (e.g., the specialist).

Rule 104 also requires any person effecting a *syndicate covering transaction*,¹²⁸ or placing or transmitting a *penalty bid*,¹²⁹ to disclose that fact to the SRO that has direct oversight authority over the principal market in the United States for the security for which the syndicate covering transaction is effected, or the penalty bid is imposed. This information will assist the exchanges and the NASD in carrying out their surveillance

¹²⁷ See *NASD Manual*, Marketplace Rules, IM-4614.

¹²⁸ Rule 100 defines syndicate covering transaction as the placing of any bid or the effecting of any purchase on behalf of the sole distributor or the underwriting syndicate or group to reduce a syndicate short position.

¹²⁹ Rule 100 defines penalty bid to mean an arrangement that permits the managing underwriter to reclaim a selling concession otherwise accruing to a syndicate member (or to a selected dealer or selling group member) in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.

responsibilities. Some commenters asserted that the information regarding aftermarket activities should be kept confidential to avoid creating the perception of a weak offering, while a few commenters urged the Commission to facilitate public dissemination of this information in order to preclude an unintended manipulative effect, and to prevent the investing public from unknowingly bearing the cost of these aftermarket activities. The rule, as adopted, requires disclosure to the SRO but does not require public disclosure. Should circumstances indicate that such disclosure is warranted, the Commission may revisit this issue.

Under Rule 104, the stabilizing legend required by Rule 10b-7, and Item 502(d) of Regulations S-B and S-K,¹³⁰ would be replaced by a brief legend identifying activity that may affect the offered security's price and directing investors to a discussion in the "plan of distribution" section of the prospectus. Item 508 of Regulations S-B and S-K, governing the plan of distribution disclosure, is amended to require a brief description of any prospective stabilizing and aftermarket activities, including syndicate covering transactions and the imposition of a penalty bid, and their potential effects on the market price.¹³¹ The objective of these proposals is to provide meaningful information to prospective investors regarding stabilizing and related activities.¹³²

In addition to the foregoing disclosure requirements, when a person subject to Rule 104 conducts transactions in securities and the price of those securities may be or has been stabilized, that person is required by paragraph (h)(3) of Rule 104 to send to a purchaser, at or before the completion of the transaction, a document containing a statement similar to that required by Item 502(d)(1)(i) of Regulations S-B and S-K. This disclosure may be made by a document, including a prospectus, confirmation, or other writing that contains language indicating that the underwriter may effect stabilizing transactions in connection with an offering of securities.¹³³ The Commission proposed, but is not

¹³⁰ See 17 CFR 228.502(d) and 229.502(d).

¹³¹ See 17 CFR 228.508 and 229.508.

¹³² Once a "plain English" prospectus is implemented, a stabilizing legend would no longer be required on the inside front cover of the prospectus, although the disclosure required by Item 508 of Regulations S-K and S-B would be retained. See *Task Force Report* 17-18.

¹³³ This disclosure requirement is not intended to extend the prospectus delivery period required by Rule 174 under the Securities Act. The required disclosure may be made by means other than the prospectus. 17 CFR 230.174.

adopting at this time, that similar disclosure be given to purchasers of securities subject to aftermarket activities. The Commission intends to reconsider the need for this disclosure as it continues to review developments in the aftermarket area.

Amendments to Rule 17a-2 under the Exchange Act require managing underwriters to keep records of syndicate covering transactions and penalty bids, in addition to stabilizing information. Records must reflect the name and class of securities, the price, date, and time for each syndicate covering transaction and whether any penalties were assessed, the names and addresses of the syndicate group members, and their respective commitments. The records also must reflect the dates when any penalty bid was in effect. The information is required to be maintained in a separate file, or in a separately retrievable format, for a period of three years, the first two years in an easily accessible place, consistent with the requirement of Exchange Act Rule 17a-4(f). The required information must be kept for any offering registered under the Securities Act, conducted pursuant to Regulation A¹³⁴ thereunder, or where the aggregate proceeds exceed \$5 million.

While several commenters opposed the disclosure, notification, and recordkeeping requirements proposed in Rule 104, particularly with respect to aftermarket activities, the Commission continues to believe that these provisions are an appropriate and effective means to monitor developments in aftermarket activities. Nevertheless, the Commission appreciates commenters' concerns that these provisions may require the implementation of new internal systems and procedures for underwriters and syndicate members. To accommodate possible revisions to broker-dealers' systems and procedures, the Commission has determined to delay the effectiveness of the recordkeeping requirements pertaining to syndicate covering transactions and penalty bids contained in Rule 17a-2 until April 1, 1997. The disclosure and notification requirements, which are contained in Rule 104 and pertain to stabilizing transactions, syndicate cover transactions, and penalty bids, will become effective on the same date as the other provisions of Regulation M.

F. Rule 105—Short Sales in Connection With an Offering

The Commission is adopting Rule 105 to replace Rule 10b-21. Rule 105, like Rule 10b-21, prohibits certain short sales from being covered with securities obtained from an underwriter, broker, or dealer who is participating in an offering. Rule 105 is intended to prevent manipulative short selling prior to a public offering by short sellers who cover their short positions by purchasing securities in the offering, thus largely avoiding exposure to market risk. Such short sales could result in a lower offering price and reduce an issuer's proceeds. Rule 105 differs from Rule 10b-21 because it covers only those short sales effected in the period commencing five business days prior to the offering's pricing and ending with such pricing, rather than the potentially much longer period of Rule 10b-21, which commenced with the filing of a registration statement or Form 1-A.¹³⁵

In its comment letter, the NASD expressed strong support for Rule 10b-21 and recommended that the current restricted period be retained because the date of the filing of a registration statement or Form 1-A can be identified with certainty in advance by potential short sellers. The NASD also urged that Rule 105 be amended to prohibit expressly a short seller from "directly or indirectly" covering short sales with securities purchased in a public offering. Another commenter suggested that the rule would be more effective if it covered transactions in related options. A third commenter urged that the exception in Rule 105 for shelf-registered offerings be eliminated.

The Commission believes that the application of Rule 105 should be limited to the period corresponding to the longest restricted period of Regulation M, which is five business days, and that short sellers contemplating a covering transaction will be in a position to know if any of their short sales were made within that five business day period. If short sales were made during this period, the short seller cannot cover those short sales with securities purchased in the offering.

As adopted, Rule 105 does not apply to short sales of derivative securities, because an extension of the rule's prohibitions to derivative securities would be inconsistent with the approach of Regulation M, which is to focus on those securities having the

greatest manipulative potential.¹³⁶ Additionally, the rule does not expressly prohibit short sellers from "directly or indirectly" covering short sales out of the offering. The Commission decided not to add the term "indirectly" to Rule 10b-21 at the time that rule was adopted, and no different arguments have been presented that would alter its decision.¹³⁷

Finally, Rule 105 retains the exclusion for shelf-registered offerings. However, it may be necessary for the Commission to reevaluate this exclusion if the availability of shelf registration is further expanded or offerings of shelf-registered equity become more commonplace.

III. Status of Interpretations, Exemptions, No-Action Positions, Injunctions, and Orders to Cease and Desist

A. Interpretations, Exemptions, and No-action Positions

In the Proposing Release, the Commission sought comment on the implications for interpretations, exemptions, and no-action positions under the former trading practices rules in light of the adoption of Regulation M. Although a few commenters highlighted interpretive issues, and some specifically requested that certain exemption or no-action letters remain in effect,¹³⁸ there was little comment on the status of interpretations, exemptions, and no-action positions generally.

Many terms and concepts in Regulation M have the same meaning as under the former trading practices rules, and interpretations under those rules regarding such terms or concepts remain relevant to the new rules. Nevertheless, because the trading practices rules are rescinded as of the effective date of Regulation M, written exemptions that were granted and no-action positions taken under those rules no longer will be in effect as of Regulation M's

¹³⁶ Any manipulative short sales involving derivatives transactions continue to be addressed by the general anti-manipulation provisions, including Section 9(a)(2) of and Rule 10b-5 under the Exchange Act.

¹³⁷ See Securities Exchange Act Release No. 26028 (August 25, 1988), 53 FR 33455, 33457.

¹³⁸ See, e.g., Letter from Peter Derendinger, General Counsel, CS Holding (June 24, 1996), to Jonathan G. Katz, Secretary, SEC, concerning *Letter regarding CS Holding*, [1995] Fed. Sec. L. Rep. (CCH) ¶ 77,018 (March 31, 1995); Letter from Dan Sheridan, Head of Market Regulation Department, London Stock Exchange (July 23, 1996), to Jonathan G. Katz, Secretary, SEC, concerning *Letter regarding London Stock Exchange*, (July 12, 1993) (permitting passive market making on the London Stock Exchange during a distribution of securities) ("LSE Letter").

¹³⁴ 17 CFR 230.251 *et seq.*

¹³⁵ 17 CFR 239.90.

effectiveness.¹³⁹ Many of the exemptions and no-action positions issued under the trading practices rules have been codified, expanded, or otherwise made redundant by Regulation M. The Commission expects, therefore, that the need to continue the relief issued under the trading practices rules after the effective date of Regulation M will be very limited.¹⁴⁰ Accordingly, if a recipient or beneficiary of an exemption or no-action letter issued under the former trading practices rules believes that the relief granted by such letter continues to be necessary or appropriate under Regulation M, that person may wish to contact the Office of Risk Management and Control of the Commission's Division of Market Regulation, at (202) 942-0772.

B. Injunctions and Orders to Cease and Desist

The Proposing Release did not address the status of outstanding injunctions or orders to cease and desist from violating the trading practices rules. The Commission is of the view that all such injunctions and orders continue in force and effect, and should be considered injunctions or orders to cease and desist from violating the corresponding successor rule or rules under Regulation M. For purposes of determining the status of an outstanding injunction or order, Rules 101 and 102 are each deemed a successor rule to Rule 10b-6; Rule 103 is deemed a successor rule to Rule 10b-6A; Rule 104 is deemed a successor rule to Rule 10b-7; and Rule 105 is deemed a successor rule to Rule 10b-21. Additionally, with respect to Commission cases alleging a violation of one or more of the trading practices rules, if a court or administrative law judge determines after the adoption of Regulation M that a violation of one or more of the trading practices rules occurred while such rules remained in effect, and an injunction or order to cease and desist would have been an appropriate remedy

at the time such rules remained in effect, the Commission believes such court or administrative law judge should issue an injunction or order to cease and desist from violating the appropriate successor rule or rules under Regulation M.

IV. Costs and Benefits of the Amendments and Their Effects on Competition, Efficiency, and Capital Formation

Section 23(a)(2) of the Exchange Act¹⁴¹ requires the Commission to consider the anti-competitive effects of any rules it adopts thereunder, and to balance them against the benefits that further the purposes of the Act. Furthermore, Section 2 of the Securities Act¹⁴² and Section 3 of the Exchange Act,¹⁴³ as amended by the recently enacted National Securities Markets Improvement Act of 1996 ("Markets Improvement Act"),¹⁴⁴ provide that whenever the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission also shall consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

In the Proposing Release, the Commission stated its view that the rules would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act.¹⁴⁵ In fact, the Commission stated that Regulation M would reduce significantly trading restrictions on issuers, underwriters, and others participating in a distribution and, therefore, should reduce the costs of raising capital. The Commission also indicated its belief that Regulation M would enhance the posture of U.S. underwriters in relation to foreign broker-dealers in competing for underwriting business in cross-border transactions.

The NYSE and the Amex argued that use of a trading volume test to determine which securities qualify for the actively-traded securities exception and the one or five day restricted period of Regulation M would have an anti-competitive effect. The NYSE and the Amex believed that the Commission's use of ADTV is discriminatory and anti-competitive because the rules make no distinction between dealer markets,

where dealer "interpositioning" is alleged to approximately double the reported volume of shares changing hands between investors, as compared with auction markets, where buyers and sellers meet directly and reported volume reflects that direct interaction as a single reported trade. These commenters asserted that the alleged "double counting" would have an anti-competitive effect on the ability of auction markets to attract new corporate listings, because it makes it more likely that distribution participants will be subject to fewer restrictions in dealer markets. The NYSE recommended that if the Commission determined that ADTV for a dealer market should be considered as the volume reported by that market, the Commission should consider the ADTV for auction markets as being twice the volume reported by those markets. Similarly, the Amex suggested that Nasdaq reported volume be adjusted downward if a measure based on ADTV is used.

As stated above, the Commission is of the view that the ADTV test provides the best measurement of a security's relative susceptibility to manipulation. Moreover, the public float test described above provides an additional control to prevent securities from being categorized based on aberrational levels of trading volume. The public float test also serves to equalize the treatment of securities traded under different market structures.

Although the NYSE and the Amex letters contend that the use of a trading volume standard in Regulation M will have an anti-competitive effect on their ability to attract corporate listings, they offer no data or other information demonstrating that the use of a trading volume concept in other rules, such as Exchange Act Rule 10b-18 or Securities Act Rule 144,¹⁴⁶ has resulted in an issuer deciding not to list on the NYSE or the Amex.

The NYSE and the Amex proposals also do not take into account the complex and evolving nature of both dealer and auction markets, and do not recommend a workable methodology for making such trading "comparable." The Commission notes that the Nasdaq market has a substantial and developing auction component,¹⁴⁷ and the exchanges have substantial dealer activity either through block positioning

¹³⁹ Regulation M is considered a major rule for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996). Thus, it is subject to a Congressional disapproval process and will not become effective until March 4, 1997. The provisions of Rules 10b-6, 10b-6A, 10b-7, 10b-8, and 10b-21 remain in effect until the effective date of their rescission, which is March 4, 1997. Persons participating in offerings are subject to the terms of the trading practices rules until they are rescinded.

¹⁴⁰ In response to a request from the London Stock Exchange, the LSE Letter shortly will be modified and reissued under Regulation M. To the extent that other letters have not been codified by Regulation M, appropriate requests for relief under Regulation M will be considered by the Division of Market Regulation.

¹⁴¹ 15 U.S.C. 78w(a)(2).

¹⁴² 15 U.S.C. 77b.

¹⁴³ 15 U.S.C. 78c.

¹⁴⁴ Pub. L. No. 104-290, § 106, 110 Stat. 3416 (1996).

¹⁴⁵ See Proposing Release, 61 FR at 17127.

¹⁴⁶ 17 CFR 230.144.

¹⁴⁷ For example, Instinet accounts for a significant proportion of the reported volume in Nasdaq securities. In addition, the Commission's recently adopted order handling rules are likely to lower the level of dealer involvement in Nasdaq order flow. See Release 34-37619A, 61 FR 48289.

or specialist dealer activity.¹⁴⁸ The NYSE and Amex do not suggest, however, that there is any need for a reduction in exchange volume based upon dealer activity.

The complexity is magnified when the focus is on individual securities rather than aggregate volume levels for a market. For example, a portion of trading in exchange-listed securities is effected in the over-the-counter ("OTC") market (by dealers) but is reported in composite exchange volume.¹⁴⁹ Moreover, the level of exchange dealer activity undoubtedly varies from security to security, and the level of dealer activity for thinly-traded exchange stocks is probably high. If the approach suggested by the NYSE and the Amex were implemented, comparability would require an analysis of the dealer component in OTC and exchange trading and application of appropriate discounts. These discount calculations for each security also would need to be constantly updated. The Commission believes that this would be a cumbersome exercise of little value.

After considering carefully the views of the NYSE and the Amex, the Commission continues to believe that Regulation M will not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act. As stated above, the Commission believes that Regulation M is necessary and appropriate in the public interest because of the changes in securities markets and the fact that the trading practices rules had become needlessly complex and imposed substantial compliance costs. Furthermore, by reducing trading restrictions, Regulation M will promote efficiency and the competitive position of U.S. underwriters, and enhance the U.S. capital formation process.

¹⁴⁸ Specialists, which are the hallmark of auction markets, have important dealer obligations. They must trade for their own accounts (i.e., as dealers) in order to maintain fair and orderly markets. See Exchange Act Rule 11b-1, 17 CFR 240.11b-1; NYSE Rule 104.

In 1995, trading by NYSE members accounted for 19.7% of NYSE reported share volume (purchases and sales) with specialist activity accounting for approximately half of this volume. *NYSE Fact Book 20*; see generally John F. Gould & Allan W. Kleidon, Market Maker Activity on Nasdaq: Implications for Trading Volume, 1 *Stanford Journal of Law, Business and Finance* 11 (1994).

¹⁴⁹ See The Nasdaq Stock Market, Inc., *The Nasdaq Stock Market 1996 Fact Book & Company Directory* 8 (1996) (4.3% of volume in exchange-listed securities was effected by Nasdaq market makers in 1995).

V. Final Regulatory Flexibility Analysis

This following discussion summarizes the Commission's Regulatory Flexibility Act analysis of Regulation M and the related amendments to other rules adopted today. A complete copy of the Final Regulatory Flexibility Act ("FRFA") is available in Public File No. S7-11-96.

The rules adopted today are intended to streamline and simplify the Commission's current anti-manipulation regulation of securities offerings by reducing the regulatory burdens on issuers, underwriters, and others with a significant interest in a securities offering, while retaining core investor protections. The new rules replace Rules 10b-6, 10b-6A, 10b-7, 10b-8, and 10b-21.

Regulation M restricts offerings, activities, and persons where there is a readily identifiable incentive to manipulate the price of an offered security. The Commission believes that Regulation M reflects the improved surveillance technology of U.S. self-regulatory organizations, enhanced market transparency of securities transactions, increased globalization of securities markets, and changed offering and syndicate processes that have developed in recent years. The Commission continues to believe that prophylactic rules provide the most appropriate framework to achieve the objectives described above.

As stated in the FRFA, the Commission believes that Regulation M will enhance the ability of small issuers to raise capital. Regulation M is less restrictive than the structure under the former trading practices rules. Moreover, the Commission believes that Regulation M balances the objective of simplified, streamlined, and more flexible regulation with its statutory mandate of investor protection in a manner more appropriate than other alternatives.

The Commission requested comment with respect to the Initial Regulatory Flexibility Analysis ("IRFA") prepared in conjunction with the Proposing Release. The Commission did not receive any comments with respect to the IRFA.

A. Rules 101 and 102

The prohibitions in Rule 10b-6 are contained in two separate rules, Rules 101 and 102. Each of these rules employ restricted periods based on the dollar value of the published ADTV of the offered security and the public float value of its issuer. The restricted periods commence one or five business days prior to the pricing of the offering

and continue until the distribution is over. The restricted periods cover the times when manipulative activity is most likely. The most actively-traded securities (i.e., those securities having a minimum ADTV value of \$1 million and whose issuer meets a \$150 million public float test) are not subject to Rule 101. With respect to the vast majority of securities distributions, the trading restrictions that existed under Rule 10b-6 are substantially reduced or eliminated.

Rule 101 does not apply to distributions of Rule 144A securities made to QIBs in transactions that are exempt under the Securities Act.¹⁵⁰ Transactions in nonconvertible investment grade debt and preferred securities, and investment-grade asset-backed securities are not covered by the rule. Derivative securities also are excluded. Further, Rule 101 permits the routine dissemination of research reports, the exercise of options and other securities, and transactions in baskets of securities containing the offered security. Rule 101 excepts inadvertent violations during the restricted period by excusing *de minimis* violations, provided that a distribution participant has in place written policies and procedures reasonably designed to achieve compliance with Regulation M's provisions. The scope of persons subject to Rule 101 is narrowed by recognizing information barriers between a distribution participant and its affiliates.

Rule 101 applies equally to all distribution participants, regardless of size. The Commission does not believe that it is practicable to exempt small entities from Rule 101 because to do so would be inconsistent with the Commission's statutory mandate to protect investors.

Rule 102 governs the activities of issuers, selling security holders, and their affiliated purchasers. This rule does not contain an exception for actively-traded securities, or many of the other exceptions in Rule 101, because issuers and selling shareholders generally are not engaged in the securities business and do not need to trade securities on their own behalf or for others. Nevertheless, issuer participants, like underwriting participants, are able to engage in market activities prior to the beginning of the applicable restricted period. During the restricted period, Rule 102 permits: odd-lot transactions; transactions in connection with issuer plans; exercises of options, warrants, rights, and similar securities;

¹⁵⁰ 17 CFR 230.144A.

transactions during Rule 144A distributions; and transactions in certain nonconvertible securities and asset-backed securities that are rated investment grade.

Rule 101 permits distribution participants to engage in a greater range of market activities during a distribution in recognition of their role as market intermediaries, independent of their function as underwriters. Because issuer participants do not have such a broad range of market obligations and have a more direct interest in the offering's outcome, Rule 102 places more restrictions on their activities during a distribution.

For many issuers, Regulation M reduces the period of trading restrictions from nine or two business days to one business day. For some securities, however, the restricted periods under Rules 101 and 102 may be longer than the cooling-off periods under Rule 10b-6 (*i.e.*, five business days as opposed to two business days) because the new rules' thresholds depend on dollar value of ADTV and of public float, rather than on the offered security's price and the number of shares held by nonaffiliates. Some of these issuers may be small entities. The Commission has determined to base the new rules' thresholds on the dollar value of the security's ADTV and the issuer's public float value because the higher the value of trading and public float, the more costly and more difficult it becomes to affect the security's price.

B. Rule 103

Rule 103 governs Nasdaq passive market making and replaces Rule 10b-6A. By eliminating the eligibility criteria contained in Rule 10b-6A, Rule 103 applies to all Nasdaq securities and nearly all distributions, and provides additional flexibility by permitting more distribution participants to engage in passive market making. The Commission no longer considers it necessary or appropriate to restrict passive market making to the narrow class of offerings where the potential liquidity loss may be substantial (*i.e.*, where syndicate members account for at least 30% of market making capacity). Rule 103 also allows less active passive market makers who might otherwise not be able to engage in a passive market making a minimum net purchase allowance of 200 shares. Some of these passive market makers may be small broker-dealers.

Rule 103 benefits small issuers and small broker-dealers because it removes the eligibility criteria of Rule 10b-6A. The eligibility criteria were designed to limit the availability of passive market

making to those firm commitment, fixed price offerings qualifying for the two business day cooling-off period of Rule 10b-6 and to those circumstances where the restrictions otherwise would have reduced market maker capacity significantly (*i.e.*, where syndicate members accounted for at least 30% of market maker capacity). By removing the eligibility criteria, more offerings and more market makers qualify for passive market making.

C. Rule 104

Rule 104 regulates stabilizing and other activities related to a distribution and replaces Rule 10b-7. The rule permits underwriters to follow the independent bid for a security in the principal market, wherever located. Certain disclosure and recordkeeping requirements are extended to the aftermarket transactions by distribution participants. Underwriters frequently engage in aftermarket activities, including covering syndicate short positions and establishing and enforcing penalty bids, that are analogous to traditional stabilizing under Rule 10b-7.

The Commission believes that Rule 104 generally concerns syndicate managers because of their role as stabilizing managers. For the most part, these syndicate managers are larger broker-dealers. To the extent small broker-dealers engage in stabilizing activities, Rule 104 applies to them with the same force as large broker-dealers.

In conjunction with Rule 104, the Commission is adopting amendments to Items 502(d) and 508 of Regulations S-K and S-B, and Rule 17a-2. These rules require revised disclosure and recordkeeping requirements on certain post-distribution activities of underwriters. Rule 104 and Item 502(d) of Regulations S-K and S-B require disclosure of stabilizing activities through a new, shorter stabilizing legend in place of the legend that had been required. In addition, Rule 104 and Item 508 of Regulations S-K and S-B expand the discussion in the plan of distribution section of the prospectus to include a "plain English" discussion of any expected stabilizing activities and other aftermarket activities and their potential effects on the marketplace with respect to the particular securities offering. Rule 17a-2 is amended to require the manager of an underwriting syndicate to maintain records related to syndicate covering transactions and penalty bids.

The Commission believes that the preponderance of the broker-dealers acting as distribution participants are not small broker-dealers, and that there is only a relatively small number of

small broker-dealers that act as distribution participants. The Commission believes, however, that any effect on small entities will be minimal because the additional disclosure in the offering materials and notification to regulatory authorities is the responsibility of the managing underwriter who is unlikely to fall within the small entity classification because of capital requirements for underwriting. The same is true of the additional recordkeeping requirements of Rule 17a-2.

D. Rule 105

Rule 105 recodifies Rule 10b-21 governing short selling in connection with a public offering. To harmonize Rule 105 with the provisions of Rules 101 and 102, the period of Rule 105's coverage is shortened to the five business day period before pricing, rather than the time extending from the filing of offering materials to the time when sales may be made. Rule 105 is less restrictive than Rule 10b-21, and applies equally to all market participants.

VI. Paperwork Reduction Act

As set forth in the Proposing Release,¹⁵¹ Rules 101, 102, 103, and 104 under Regulation M and the amendments to Rule 17a-2 and to Items 502(d) and 508 of Regulations S-B and S-K contain collections of information within the meaning of the Paperwork Reduction Act of 1995 ("PRA").¹⁵² Accordingly, the collection of information requirements contained in the rules and related amendments were submitted to the Office of Management and Budget ("OMB") for review and were approved by OMB which assigned the following control numbers: Rule 101, control number 3235-0464; Rule 102, control number 3235-0467; Rule 103, control number 3235-0466; Rule 104, control number 3235-0465; Amendments to Rule 17a-2, control number 3235-0201; Amendments to Items 502(d) and 508 of Regulation S-B, control number 3235-0418; and Amendments to Item 502(d) and 508 of Regulation S-K, control number 3235-0071. The collection of information requirements are in accordance with Section 3507 of the PRA.¹⁵³ An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the agency displays a valid OMB control number.

¹⁵¹ 61 FR at 17127.

¹⁵² 44 U.S.C. 3501 *et seq.*

¹⁵³ 44 U.S.C. 3507.

The collections of information under Regulation M and the related amendments are necessary for covered persons to obtain certain benefits or to comply with certain requirements. As described in more detail in the Proposing Release, the collections of information are necessary to provide the Commission with information regarding syndicate covering transactions and penalty bids.¹⁵⁴ The Commission may review this information during periodic examinations or with respect to investigations. Except for the information required to be kept under Rule 104(i) and Rule 17a-2(c), none of the information required to be collected or disclosed for PRA purposes will be kept confidential. If the records required to be kept pursuant to these rules are requested by and submitted to the Commission, they will be kept confidential to the extent permitted by statutory and regulatory provisions.

Several commenters provided comments regarding the Commission's estimate of the burdens associated with the recordkeeping requirement under Rule 104 and the related amendment to Rule 17a-2. Rule 104(i) and Rule 17a-2(c) require underwriters to keep records of syndicate covering transactions and penalty bids, in addition to the stabilizing information required prior to these amendments. The NASD suggested that the Commission review its estimated time for recordkeeping for syndicate covering transactions and penalty bids.¹⁵⁵ While they did not challenge specific burden estimates, two other commenters noted generally that the change in recordkeeping requirements will be more burdensome than represented by the Commission.¹⁵⁶ The Securities Industry Association asserted that the amendments would require system changes and retraining for underwriters. None of these commenters, however, provided specific alternatives to the Commission's estimates.

After carefully considering these comments, and based upon further review of the disclosure, notification, and recordkeeping changes required by Rule 104(h) and the amendment to Rule 17a-2(c), the Commission is retaining its burden estimates for the recordkeeping obligation under Rule 104 and the amendment to Rule 17a-2. Thus, the descriptions and estimated burdens of the collection of information requirements under Regulation M have

not changed, and are set forth in the Proposing Release.¹⁵⁷

VII. Statutory Basis and Text of Rules and Amendments

Rules 10b-6, 10b-6A, 10b-7, 10b-8, and 10b-21 are removed pursuant to, and the amendments to Rule 17a-2 are adopted under, the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly Sections 2, 3, 9(a)(6), 10(a), 10(b), 13(e), 15(c), 17(a), and 23(a), 15 U.S.C. 78b, 78c, 78i(a)(6), 78j(a), 78j(b), 78m(e), 78o(c), 78q(a), and 78w(a). The amendments to Items 502(d) and 508 of Regulations S-B and S-K are adopted under the Securities Act, 15 U.S.C. 77a *et seq.*, particularly Sections 6, 7, 8, 10, and 19(a), 15 U.S.C. 77f, 77g, 77h, 77j, and 77s(a); the Exchange Act, 15 U.S.C. 78a *et seq.*, particularly Sections 3, 4, 10, 12, 13, 14, 15, 16, and 23, 15 U.S.C. 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78p, and 78w; and the Investment Company Act, 15 U.S.C. 80a-1 *et seq.*, particularly Sections 8 and 38(a), 15 U.S.C. 80a-8 and 80a-37(a). Regulation M is adopted under the Securities Act, 15 U.S.C. 77a *et seq.*, particularly Sections 7, 17(a), 19(a), 15 U.S.C. 77g, 77q(a), and 77s(a); the Exchange Act, 15 U.S.C. 78a *et seq.*, particularly Sections 2, 3, 9(a), 10, 11A(c), 12, 13, 14, 15(c), 15(g), 17(a), 23(a), and 30, 15 U.S.C. 78b, 78c, 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(c), 78o(g), 78q(a), 78w(a), and 78dd-1; and the Investment Company Act, 15 U.S.C. 80a-1 *et seq.*, particularly Sections 23, 30, and 38, 15 U.S.C. 80a-23, 80a-29, and 80a-37. The necessary nomenclature amendments to Sections 200.30-3, 230.418, 230.461, 240.11a-1, 240.13e-4, 240.13e-102, and 240.14d-102 of this chapter, reflecting the removal of Rules 10b-6, 10b-6A, 10b-7, and 10b-8 under the Exchange Act and the adoption of Regulation M, are adopted pursuant to the authority cited above with respect to those amendments.

List of Subjects

17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government agencies), Sunshine Act.

17 CFR Part 228

Reporting and recordkeeping requirements, Securities, Small businesses.

17 CFR Part 229

Reporting and recordkeeping requirements, Securities.

17 CFR Part 230

Reporting and recordkeeping requirements, Securities.

17 CFR Part 240

Broker-dealers, Fraud, Issuers, Reporting and recordkeeping requirements, Securities.

17 CFR Part 242

Broker-dealers, Fraud, Issuers, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

1. The authority citation for part 200 continues to read, in part, as follows:

Authority: 15 U.S.C. 77s, 78d-1, 78d-2, 78w, 78ll(d), 79t, 77sss, 80a-37, 80b-11, unless otherwise noted.

* * * * *

2. Section 200.30-3 is amended by revising paragraph (a)(6) to read as follows:

§ 200.30-3 Delegation of authority to Director of Division of Market Regulation.

* * * * *

(a) * * *
(6) Pursuant to Rules 10b-13(d), 14e-4(c), and 15c2-11(h) (§§ 240.10b-13(d), 240.14e-4(c), and 240.15c2-11(h) of this chapter), and Rules 101(d), 102(e), 104(j), and 105(c) of Regulation M (§§ 242.101(d), 242.102(e), 242.104(j), and 242.105(c) of this chapter), to grant requests for exemptions from Rules 10b-13, 14e-4, and 15c2-11 (§§ 240.10b-13, 240.14e-4, and 240.15c2-11 of this chapter), and Rules 101, 102, 104, and 105 of Regulation M (§§ 242.101, 242.102, 242.104, and 242.105 of this chapter).

* * * * *

PART 228—INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

3. The authority citation for part 228 continues to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78w, 78ll, 80a-8, 80a-29, 80a-30, 80a-37, 80b-11, unless otherwise noted.

4. Section 228.502 is amended by revising the introductory text of paragraph (d)(1) and paragraph (d)(1)(i) to read as set forth below and by removing the phrase "RULE 10b-6A UNDER THE SECURITIES EXCHANGE

¹⁵⁴ See Proposing Release, 61 FR at 17127-30.

¹⁵⁵ NASD Comment Letter, *supra* note 31, at p. 9.

¹⁵⁶ Comment letter from the Securities Industry Association (July 16, 1996), at p. 13; Comment letter from J.P. Morgan Securities Inc., at p. 4.

¹⁵⁷ See Proposing Release, 61 FR at 17127-30.

ACT OF 1934" from paragraph (d)(2) and adding, in its place, the phrase "RULE 103 OF REGULATION M".

§ 228.502 (Item 502) Inside front and outside back cover pages of prospectus.

* * * * *

(d)(1) *Stabilizing and other transactions.* (i) Include the following statement, if true, subject to appropriate modification where circumstances require.

Certain persons participating in this offering may engage in transactions that stabilize, maintain, or otherwise affect the price of (identify securities), including (list types of transactions). For a description of these activities, see "Plan of Distribution."

* * * * *

5. Section 228.508 is amended by removing the phrase "§ 240.10b-6A of this chapter" from paragraph (i) and adding, in its place, the phrase "Rule 103 of Regulation M (§ 242.103 of this chapter)" and by adding paragraph (j) to read as follows:

§ 228.508 (Item 508) Plan of distribution.

* * * * *

(j) *Stabilizing and other transactions.* If the underwriter or any selling group member intends to engage in stabilizing, syndicate short covering transactions, penalty bids, or any other transaction during the offering that may stabilize, maintain, or otherwise affect the offered security's price, indicate such intention and briefly describe such transaction(s).

PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975—REGULATION S-K

6. The authority citation for part 229 continues to read, in part, as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78w, 78ll(d), 79e, 79n, 79t, 80a-8, 80a-29, 80a-30, 80a-37, 80b-11, unless otherwise noted.

* * * * *

7. Section 229.502 is amended by revising the introductory text of paragraph (d)(1) and paragraph (d)(1)(i) to read as set forth below and by removing the phrases "§ 240.10b-6A of this chapter" and "RULE 10b-6A UNDER THE SECURITIES EXCHANGE ACT OF 1934" from paragraph (d)(2) and adding, in their places, the phrases "§ 242.103 of this chapter" and "RULE 103 OF REGULATION M", respectively.

§ 229.502 (Item 502) Inside front and outside back cover pages of prospectus.

* * * * *

(d)(1) *Stabilizing and other transactions.* (i) Include the following statement, if true, subject to appropriate modification where circumstances require.

Certain persons participating in this offering may engage in transactions that stabilize, maintain, or otherwise affect the price of (identify securities), including (list types of transactions). For a description of these activities, see "Plan of Distribution."

* * * * *

8. Section 229.508 is amended by removing the phrase "§ 240.10b-6A of this chapter" from paragraph (k) and adding, in its place, the phrase "Rule 103 of Regulation M (§ 242.103 of this chapter)" and by adding paragraph (l) to read as follows:

§ 229.508 (Item 508) Plan of distribution.

* * * * *

(l) *Stabilizing and other transactions.* If the underwriter or any selling group member intends to engage in stabilizing, syndicate short covering transactions, penalty bids, or any other transaction during the offering that may stabilize, maintain, or otherwise affect the security's price, indicate such intention and briefly describe such transaction(s).

PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

9. The authority citation for part 230 continues to read, in part, as follows:

Authority: 15 U.S.C. 77b, 77f, 77g, 77h, 77j, 77s, 77sss, 78c, 78d, 78l, 78m, 78n, 78o, 78w, 78ll(d), 79t, 80a-8, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

§ 230.418 [Amended]

10. Section 230.418 is amended by removing the phrase "*offering at the market*, as defined in Rule 10b-7 under the Securities Exchange Act of 1934 (17 CFR 240.10b-7)" from paragraph (a)(4) and adding, in its place, the phrase "*at-the-market offering*, as defined in § 242.100 of this chapter".

§ 230.461 [Amended]

11. Section 230.461 is amended by removing the phrase "Rules 10b-2, 10b-6, and 10b-7 under the Securities Exchange Act of 1934 (§§ 240.10b-6 and 10b-7 of this chapter)" from paragraph (b)(7) and adding, in its place, the phrase "Regulation M (§§ 242.100 through 242.105 of this chapter)".

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

12. The authority citation for part 240 is amended by removing the subauthorities for "Section 240.10b-6" and "Section 240.10b-21" and the general authority continues to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78ll(d), 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

§ 240.10a-1 [Amended]

13. Section 240.10a-1 is amended by removing the cite "§ 240.10b-7" from the introductory text of paragraph (e)(5) and paragraphs (e)(6) and (e)(11), and adding, in its place, the phrase "§ 242.104 of this chapter" and by removing the phrase "pursuant to § 240.10-8" from paragraph (e)(10).

§ 240.10b-6 [Removed and Reserved]

14. Section 240.10b-6 is removed and reserved.

§ 240.10b-6A [Removed]

15. Section 240.10b-6A is removed.

§§ 240.10b-7 and 240.10b-8 [Removed and Reserved]

16. Sections 240.10b-7 and 240.10b-8 are removed and reserved.

17. Section 240.10b-18 is amended by redesignating paragraphs (a)(3)(i) through (a)(3)(vi) as paragraphs (a)(3)(ii) through (a)(3)(vii), and by adding paragraph (a)(3)(i) and revising paragraphs (a)(5) and (a)(6) to read as follows:

§ 240.10b-18 Purchases of certain equity securities by the issuer and others.

(a) * * *

(3) * * *

(i) Effected during the restricted period specified in § 242.102 of this chapter during a distribution (as defined in § 242.100 of this chapter) of such common stock, or during a distribution for which such common stock is a reference security, by the issuer or any of its affiliated purchasers;

* * * * *

(5) The term *plan* has the meaning contained in § 242.100 of this chapter;

(6) The term *agent independent of the issuer* has the meaning contained in § 242.100 of this chapter;

* * * * *

§ 240.10b-21 [Removed and Reserved]

17. Section 240.10b-21 is removed and reserved.

§ 240.11a-1 [Amended]

18. Section 240.11a-1 is amended by removing the phrase “§ 240.10b-7 (Rule 10b-7)” from paragraph (b)(3) and adding, in its place, the phrase “§ 242.104 of this chapter”.

§ 240.13e-4 [Amended]

19. Section 240.13e-4 is amended by removing the phrase “an issuer’s plan as that term is defined in Rule 10b-6(c)(4) under the Act [§ 240.10b-6(c)(4)]” from paragraph (h)(5)(i) and adding, in its place, the phrase “a plan as that term is defined in § 242.100 of this chapter”.

20. Section 240.13e-102 is amended by revising General Instruction III.C. to Schedule 13E-4F to read as follows:

§ 240.13e-102 Schedule 13E-4F. Tender offer statement pursuant to section 13(e)(1) of the Securities Exchange Act of 1934 and § 240.13e-4 thereunder.

* * * * *

General Instructions

* * * * *

III. Compliance With the Exchange Act

* * * * *

C. The issuer’s attention is directed to Regulation M (§§ 242.100 through 242.105 of this chapter), in the case of an issuer exchange offer, and to Rule 10b-13 under the Exchange Act (§ 240.10b-13), in the case of an issuer cash tender offer or issuer exchange offer. [See Exchange Act Release No. 29355 (June 21, 1991) containing an exemption from Rule 10b-13.]

* * * * *

21. Section 240.14d-102 is amended by revising General Instruction III.C. to Schedule 14D-1F to read as follows:

§ 240.14d-102 Schedule 14D-1F. Tender offer statement pursuant to Rule 14d-1(b) under the Securities Exchange Act of 1934.

* * * * *

General Instructions

* * * * *

III. Compliance With the Exchange Act

* * * * *

C. The bidder’s attention is directed to Regulation M (§§ 242.100 through 242.105 of this chapter) in the case of an exchange offer, and to Rule 10b-13 under the Exchange Act (§ 240.10b-13) for any exchange or cash tender offer. [See Exchange Act Release No. 29355 (June 21, 1991) containing an exemption from Rule 10b-13.]

* * * * *

22. Section 240.17a-2 is amended by revising paragraph (a), the introductory text of paragraph (b), paragraph (b)(1), the introductory text of paragraph (c), and paragraphs (c)(1) and (d) to read as follows:

§ 240.17a-2 Recordkeeping requirements relating to stabilizing activities.

(a) Scope of section. This section shall apply to any person who effects any purchase of a security subject to § 242.104 of this chapter for the purpose of, or who participates in a syndicate or group that engages in, “stabilizing,” as defined in § 242.100 of this chapter, the price of any security; or effects a purchase that is a “syndicate covering transaction,” as defined in § 242.100 of this chapter; or imposes a “penalty bid,” as defined in § 242.100 of this chapter:

(1) With respect to which a registration statement has been, or is to be, filed pursuant to the Securities Act of 1933 (15 U.S.C. 77a et seq.); or

(2) Which is being, or is to be, offered pursuant to an exemption from registration under Regulation A (§§ 230.251 through 230.263 of this chapter) adopted under the Securities Act of 1933 (15 U.S.C. 77a et seq.); or

(3) Which is being, or is to be, otherwise offered, if the aggregate offering price of the securities being offered exceeds \$5,000,000.

(b) Definitions. For purposes of this section, the following definitions shall apply:

(1) The term manager shall mean the person stabilizing or effecting syndicate covering transactions or imposing a penalty bid for its sole account or for the account of a syndicate or group in which it is a participant, and who, by contract or otherwise, deals with the issuer, organizes the selling effort, receives some benefit from the underwriting that is not shared by other underwriters, or represents any other underwriters in such matters as maintaining the records of the distribution and arranging for allotments of the securities offered.

* * * * *

(c) Records relating to stabilizing, syndicate covering transactions, and penalty bids required to be maintained by manager. Any person subject to this section who acts as a manager and stabilizes or effects syndicate covering transactions or imposes a penalty bid shall:

(1) Promptly record and maintain the following separately retrievable information, for a period of not less than three years, the first two years in an easily accessible place; Provided, however, That if the information is in a record required to be made pursuant to § 240.17a-3 or § 240.17a-4, or otherwise preserved, such information need not be maintained in a separate file if the person can sort promptly and retrieve the information as if it had been kept in a separate file as a record made

pursuant to, and preserves the information in accordance with the time periods specified in, this paragraph (c)(1):

(i) The name and class of any security stabilized or any security in which syndicate covering transactions have been effected or a penalty bid has been imposed;

(ii) The price, date, and time at which each stabilizing purchase or syndicate covering transaction was effected by the manager or by any participant in the syndicate or group, and whether any penalties were assessed;

(iii) The names and the addresses of the members of the syndicate or group;

(iv) Their respective commitments, or, in the case of a standby or contingent underwriting, the percentage participation of each member of the syndicate or group therein; and

(v) The dates when any penalty bid was in effect.

* * * * *

(d) Notification to manager. Any person who has a participation in a syndicate account but who is not a manager of such account, and who effects one or more stabilizing purchases or syndicate covering transactions for its sole account or for the account of a syndicate or group, shall within three business days following such purchase notify the manager of the price, date, and time at which such stabilizing purchase or syndicate covering transaction was effected, and shall in addition notify the manager of the date and time when such stabilizing purchase or syndicate covering transaction was terminated. The manager shall maintain such notifications in a separate file, together with the information required by paragraph (c)(1) of this section, for a period of not less than three years, the first two years in an easily accessible place.

23. Part 242 is added to read as follows:

PART 242—REGULATION M

- Sec. 242.100 Preliminary note; definitions. 242.101 Activities by distribution participants. 242.102 Activities by issuers and selling security holders during a distribution. 242.103 Nasdaq passive market making. 242.104 Stabilizing and other activities in connection with an offering. 242.105 Short selling in connection with a public offering. Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(c), 78o(g), 78q(a), 78q(h), 78w(a), 78dd-1, 80a-23, 80a-29, and 80a-37.

§ 242.100 Preliminary note; definitions.

(a) *Preliminary note:* Any transaction or series of transactions, whether or not effected pursuant to the provisions of Regulation M (§§ 242.100–242.105 of this chapter), remain subject to the antifraud and antimanipulation provisions of the securities laws, including, without limitation, Section 17(a) of the Securities Act of 1933 [15 U.S.C. 77q(a)] and Sections 9, 10(b), and 15(c) of the Securities Exchange Act of 1934 [15 U.S.C. 78i, 78j(b), and 78o(c)].

(b) For purposes of regulation M (§§ 242.100 through 242.105 of this chapter) the following definitions shall apply:

ADTV means the worldwide average daily trading volume during the two full calendar months immediately preceding, or any 60 consecutive calendar days ending within the 10 calendar days preceding, the filing of the registration statement; or, if there is no registration statement or if the distribution involves the sale of securities on a delayed basis pursuant to § 230.415 of this chapter, two full calendar months immediately preceding, or any consecutive 60 calendar days ending within the 10 calendar days preceding, the determination of the offering price.

Affiliated purchaser means:

(1) A person acting, directly or indirectly, in concert with a distribution participant, issuer, or selling security holder in connection with the acquisition or distribution of any covered security; or

(2) An affiliate, which may be a separately identifiable department or division of a distribution participant, issuer, or selling security holder, that, directly or indirectly, controls the purchases of any covered security by a distribution participant, issuer, or selling security holder, whose purchases are controlled by any such person, or whose purchases are under common control with any such person; or

(3) An affiliate, which may be a separately identifiable department or division of a distribution participant, issuer, or selling security holder, that regularly purchases securities for its own account or for the account of others, or that recommends or exercises investment discretion with respect to the purchase or sale of securities; *Provided, however,* That this paragraph (3) shall not apply to such affiliate if the following conditions are satisfied:

(i) The distribution participant, issuer, or selling security holder:

(A) Maintains and enforces written policies and procedures reasonably designed to prevent the flow of information to or from the affiliate that

might result in a violation of §§ 242.101, 242.102, and 242.104; and

(B) Obtains an annual, independent assessment of the operation of such policies and procedures; and

(ii) The affiliate has no officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel) in common with the distribution participant, issuer, or selling security holder that direct, effect, or recommend transactions in securities; and

(iii) The affiliate does not, during the applicable restricted period, act as a market maker (other than as a specialist in compliance with the rules of a national securities exchange), or engage, as a broker or a dealer, in solicited transactions or proprietary trading, in covered securities.

Agent independent of the issuer means a trustee or other person who is independent of the issuer. The agent shall be deemed to be independent of the issuer only if:

(1) The agent is not an affiliate of the issuer; and

(2) Neither the issuer nor any affiliate of the issuer exercises any direct or indirect control or influence over the prices or amounts of the securities to be purchased, the timing of, or the manner in which, the securities are to be purchased, or the selection of a broker or dealer (other than the independent agent itself) through which purchases may be executed; *Provided, however,* That the issuer or its affiliate will not be deemed to have such control or influence solely because it revises not more than once in any three-month period the basis for determining the amount of its contributions to a plan or the basis for determining the frequency of its allocations to a plan, or any formula specified in a plan that determines the amount or timing of securities to be purchased by the agent.

Asset-backed security has the meaning contained in General Instruction I.B.5. to Form S-3 (§ 239.13 of this chapter).

At-the-market offering means an offering of securities at other than a fixed price.

Business day means a 24 hour period beginning at midnight that includes an entire trading session for the security to be distributed.

Completion of participation in a distribution. Securities acquired in the distribution for investment by any person participating in a distribution, or any affiliated purchaser of such person, shall be deemed to be distributed. A person shall be deemed to have

completed its participation in a distribution as follows:

(1) An issuer or selling security holder, when the distribution is completed;

(2) An underwriter, when such person's participation has been distributed, including all other securities of the same class that are acquired in connection with the distribution, and any stabilization arrangements and trading restrictions in connection with the distribution have been terminated; *Provided, however,* That an underwriter's participation will not be deemed to have been completed if a syndicate overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of such exercise; and

(3) Any other person participating in the distribution, when such person's participation has been distributed.

Covered security means any security that is the subject of a distribution, or any reference security.

Current exchange rate means the current rate of exchange between two currencies, which is obtained from at least one independent entity that provides or disseminates foreign exchange quotations in the ordinary course of its business.

Distribution means an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.

Distribution participant means an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution.

Electronic communications network has the meaning contained in § 240.11Ac1-1(a)(8) of this chapter.

Employee has the meaning contained in Form S-8 (§ 239.16b of this chapter) relating to employee benefit plans.

Exchange Act means the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.).

Independent bid means a bid by a person who is not a distribution participant, issuer, selling security holder, or affiliated purchaser.

NASD means the National Association of Securities Dealers, Inc. or any of its subsidiaries.

Nasdaq means the Nasdaq system as defined in § 240.11Ac1-2(a)(3) of this chapter.

Nasdaq security means a security that is authorized for quotation on Nasdaq, and such authorization is not suspended, terminated, or prohibited.

Net purchases means the amount by which a passive market maker's purchases exceed its sales.

Offering price means the price at which the security is to be or is being distributed.

Passive market maker means a market maker that effects bids or purchases in accordance with the provisions of § 242.103.

Penalty bid means an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.

Plan means any bonus, profit-sharing, pension, retirement, thrift, savings, incentive, stock purchase, stock option, stock ownership, stock appreciation, dividend reinvestment, or similar plan; or any dividend or interest reinvestment plan or employee benefit plan as defined in § 230.405 of this chapter.

Principal market means the single securities market with the largest aggregate reported trading volume for the class of securities during the 12 full calendar months immediately preceding the filing of the registration statement; or, if there is no registration statement or if the distribution involves the sale of securities on a delayed basis pursuant to § 230.415 of this chapter, during the 12 full calendar months immediately preceding the determination of the offering price. For the purpose of determining the aggregate trading volume in a security, the trading volume of depositary shares representing such security shall be included, and shall be multiplied by the multiple or fraction of the security represented by the depositary share. For purposes of this paragraph, depositary share means a security, evidenced by a depositary receipt, that represents another security, or a multiple or fraction thereof, deposited with a depositary.

Prospective underwriter means a person:

(1) Who has submitted a bid to the issuer or selling security holder, and who knows or is reasonably certain that such bid will be accepted, whether or not the terms and conditions of the underwriting have been agreed upon; or

(2) Who has reached, or is reasonably certain to reach, an understanding with the issuer or selling security holder, or managing underwriter that such person will become an underwriter, whether or not the terms and conditions of the underwriting have been agreed upon.

Public float value shall be determined in the manner set forth on the front page of Form 10-K (§ 249.310 of this

chapter), even if the issuer of such securities is not required to file Form 10-K, relating to the aggregate market value of common equity securities held by non-affiliates of the issuer.

Reference period means the two full calendar months immediately preceding the filing of the registration statement or, if there is no registration statement or if the distribution involves the sale of securities on a delayed basis pursuant to § 230.415 of this chapter, the two full calendar months immediately preceding the determination of the offering price.

Reference security means a security into which a security that is the subject of a distribution ("subject security") may be converted, exchanged, or exercised or which, under the terms of the subject security, may in whole or in significant part determine the value of the subject security.

Restricted period 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.

Securities Act means the Securities Act of 1933 (15 U.S.C. 77a et seq.).

Selling security holder means any person on whose behalf a distribution is made, other than an issuer.

Stabilize or stabilizing means the placing of any bid, or the effecting of any purchase, for the purpose of pegging, fixing, or maintaining the price of a security.

Syndicate covering transaction means the placing of any bid or the effecting of any purchase on behalf of the sole distributor or the underwriting syndicate or group to reduce a short position created in connection with the offering.

30% ADTV limitation means 30 percent of the market maker's ADTV in a covered security during the reference period, as obtained from the NASD.

Underwriter means a person who has agreed with an issuer or selling security holder:

(1) To purchase securities for distribution; or

(2) To distribute securities for or on behalf of such issuer or selling security holder; or

(3) To manage or supervise a distribution of securities for or on behalf of such issuer or selling security holder.

§ 242.101 Activities by distribution participants.

(a) *Unlawful Activity.* In connection with a distribution of securities, it shall be unlawful for a distribution participant or an affiliated purchaser of such person, directly or indirectly, to bid for, purchase, or attempt to induce any person to bid for or purchase, a covered security during the applicable restricted period; *Provided, however,* That if a distribution participant or affiliated purchaser is the issuer or selling security holder of the securities subject to the distribution, such person shall be subject to the provisions of § 242.102, rather than this section.

(b) *Excepted Activity.* The following activities shall not be prohibited by paragraph (a) of this section:

(1) *Research.* The publication or dissemination of any information, opinion, or recommendation, if the conditions of §§ 230.138 or 230.139 of this chapter are met; or

(2) *Transactions complying with certain other sections.* Transactions complying with §§ 242.103 or 242.104; or

(3) *Odd-lot transactions.* Transactions in odd-lots; or transactions to offset odd-lots in connection with an odd-lot tender offer conducted pursuant to § 240.13e-4(h)(5) of this chapter; or

(4) *Exercises of securities.* The exercise of any option, warrant, right, or any conversion privilege set forth in the instrument governing a security; or

(5) *Unsolicited transactions.* Unsolicited brokerage transactions; or unsolicited purchases that are not effected from or through a broker or dealer, on a securities exchange, or through an inter-dealer quotation system or electronic communications network; or

(6) *Basket transactions.* (i) Bids or purchases, in the ordinary course of business, in connection with a basket of 20 or more securities in which a covered security does not comprise more than 5% of the value of the basket purchased; or

(ii) Adjustments to such a basket in the ordinary course of business as a result of a change in the composition of a standardized index; or

(7) *De minimis transactions.* Purchases during the restricted period, other than by a passive market maker, that total less than 2% of the ADTV of the security being purchased, or unaccepted bids; *Provided, however,* That the person making such bid or purchase has maintained and enforces written policies and procedures reasonably designed to achieve compliance with the other provisions of this section; or

(8) *Transactions in connection with a distribution.* Transactions among distribution participants in connection with a distribution, and purchases of securities from an issuer or selling security holder in connection with a distribution, that are not effected on a securities exchange, or through an inter-dealer quotation system or electronic communications network; or

(9) *Offers to sell or the solicitation of offers to buy.* Offers 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; or

(10) *Transactions in Rule 144A securities.* Transactions in securities eligible for resale under § 230.144A(d)(3) of this chapter, or any reference security, if the Rule 144A securities are offered or sold in the United States solely to:

(i) Qualified institutional buyers, as defined in § 230.144A(a)(1) of this chapter, or to offerees or purchasers that the seller and any person acting on behalf of the seller reasonably believes are qualified institutional buyers, in transactions exempt from registration under section 4(2) of the Securities Act (15 U.S.C. 77d(2)) or §§ 230.144A or 230.501 through 230.508 of this chapter; or

(ii) Persons not deemed to be "U.S. persons" for purposes of §§ 230.902(o)(2) or 230.902(o)(7) of this chapter, during a distribution qualifying under paragraph (b)(10)(i) of this section.

(c) *Excepted Securities.* The provisions of this section shall not apply to any of the following securities:

(1) *Actively-traded securities.* Securities that have an ADTV value of at least \$1 million and are issued by an issuer whose common equity securities have a public float value of at least \$150 million; *Provided, however,* That such securities are not issued by the distribution participant or an affiliate of the distribution participant; or

(2) *Investment grade nonconvertible and asset-backed securities.* Nonconvertible debt securities,

nonconvertible preferred securities, and asset-backed securities, that are rated by at least one nationally recognized statistical rating organization, as that term is used in § 240.15c3-1 of this chapter, in one of its generic rating categories that signifies investment grade; or

(3) *Excepted securities.* "Excepted securities" as defined in section 3(a)(12) of the Exchange Act (15 U.S.C. 78c(a)(12)); or

(4) *Face-amount certificates or securities issued by an open-end management investment company or unit investment trust.* Face-amount certificates issued by a face-amount certificate company, or redeemable securities issued by an open-end management investment company or a unit investment trust. Any terms used in this paragraph (c)(4) that are defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*) shall have the meanings specified in such Act.

(d) *Exemptive Authority.* Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities.

§ 242.102 Activities by issuers and selling security holders during a distribution.

(a) *Unlawful Activity.* In connection with a distribution of securities effected by or on behalf of an issuer or selling security holder, it shall be unlawful for such person, or any affiliated purchaser of such person, directly or indirectly, to bid for, purchase, or attempt to induce any person to bid for or purchase, a covered security during the applicable restricted period; *Except That* if an affiliated purchaser is a distribution participant, such affiliated purchaser may comply with § 242.101, rather than this section.

(b) *Excepted Activity.* The following activities shall not be prohibited by paragraph (a) of this section:

(1) *Odd-lot transactions.* Transactions in odd-lots, or transactions to offset odd-lots in connection with an odd-lot tender offer conducted pursuant to § 240.13e-4(h)(5) of this chapter; or

(2) *Transactions by closed-end investment companies.* (i) Transactions complying with § 270.23c-3 of this chapter; or

(ii) Periodic tender offers of securities, at net asset value, conducted pursuant to § 240.13e-4 of this chapter by a closed-end investment company that engages in a continuous offering of its securities pursuant to § 230.415 of this chapter; *Provided, however,* That such

securities are not traded on a securities exchange or through an inter-dealer quotation system or electronic communications network; or

(3) *Redemptions by commodity pools or limited partnerships.* Redemptions by commodity pools or limited partnerships, at a price based on net asset value, which are effected in accordance with the terms and conditions of the instruments governing the securities; *Provided, however,* That such securities are not traded on a securities exchange, or through an inter-dealer quotation system or electronic communications network; or

(4) *Exercises of securities.* The exercise of any option, warrant, right, or any conversion privilege set forth in the instrument governing a security; or

(5) *Offers to sell or the solicitation of offers to buy.* Offers to sell or the solicitation of offers to buy the securities being distributed; or

(6) *Unsolicited purchases.* Unsolicited purchases that are not effected from or through a broker or dealer, on a securities exchange, or through an inter-dealer quotation system or electronic communications network; or

(7) *Transactions in Rule 144A securities.* Transactions in securities eligible for resale under § 230.144A(d)(3) of this chapter, or any reference security, if the Rule 144A securities are offered or sold in the United States solely to:

(i) Qualified institutional buyers, as defined in § 230.144A(a)(1) of this chapter, or to offerees or purchasers that the seller and any person acting on behalf of the seller reasonably believes are qualified institutional buyers, in transactions exempt from registration under section 4(2) of the Securities Act (15 U.S.C. 77d(2)) or §§ 230.144A or 230.501 through 230.508 of this chapter; or

(ii) Persons not deemed to be "U.S. persons" for purposes of §§ 230.902(o)(2) or 230.902(o)(7) of this chapter, during a distribution qualifying under paragraph (b)(6)(i) of this section.

(c) *Plans.*—(1) Paragraph (a) of this section shall not apply to distributions of securities pursuant to a plan, which are made:

(i) Solely to employees or security holders of an issuer or its subsidiaries, or to a trustee or other person acquiring such securities for the accounts of such persons; or

(ii) To persons other than employees or security holders, if bids for or purchases of securities pursuant to the plan are effected solely by an agent independent of the issuer and the securities are from a source other than

the issuer or an affiliated purchaser of the issuer.

(2) Bids for or purchases of any security made or effected by or for a plan shall be deemed to be a purchase by the issuer unless the bid is made, or the purchase is effected, by an agent independent of the issuer.

(d) *Excepted Securities.* The provisions of this section shall not apply to any of the following securities:

(1) *Actively-traded reference securities.* Reference securities with an ADTV value of at least \$1 million that are issued by an issuer whose common equity securities have a public float value of at least \$150 million; *Provided, however,* That such securities are not issued by the issuer, or any affiliate of the issuer, of the security in distribution.

(2) *Investment grade nonconvertible and asset-backed securities.* Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that are rated by at least one nationally recognized statistical rating organization, as that term is used in § 240.15c3-1 of this chapter, in one of its generic rating categories that signifies investment grade; or

(3) *Exempted securities.* "Exempted securities" as defined in section 3(a)(12) of the Exchange Act (15 U.S.C. 78c(a)(12)); or

(4) *Face-amount certificates or securities issued by an open-end management investment company or unit investment trust.* Face-amount certificates issued by a face-amount certificate company, or redeemable securities issued by an open-end management investment company or a unit investment trust. Any terms used in this paragraph (d)(4) that are defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*) shall have the meanings specified in such Act.

(e) *Exemptive Authority.* Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities.

§ 242.103 Nasdaq passive market making.

(a) *Scope of Section.* This section permits broker-dealers to engage in market making transactions in covered securities that are Nasdaq securities without violating the provisions of § 242.101; *Except That* this section shall not apply to any security for which a stabilizing bid subject to § 242.104 is in effect, or during any at-the-market offering or best efforts offering.

(b) *Conditions to be Met.*

(1) *General limitations.* A passive market maker must effect all transactions in the capacity of a registered market maker on Nasdaq. A passive market maker shall not bid for or purchase a covered security at a price that exceeds the highest independent bid for the covered security at the time of the transaction, except as permitted by paragraph (b)(3) of this section or required by a rule promulgated by the Commission or the NASD governing the handling of customer orders.

(2) *Purchase limitation.* On each day of the restricted period, a passive market maker's net purchases shall not exceed the greater of its 30% ADTV limitation or 200 shares (together, "purchase limitation"); *Provided, however,* That a passive market maker may purchase all of the securities that are part of a single order that, when executed, results in its purchase limitation being equalled or exceeded. If a passive market maker's net purchases equal or exceed its purchase limitation, it shall withdraw promptly its quotations from Nasdaq. If a passive market maker withdraws its quotations pursuant to this paragraph, it may not effect any bid or purchase in the covered security for the remainder of that day, irrespective of any later sales during that day, unless otherwise permitted by § 242.101.

(3) *Requirement to lower the bid.* If all independent bids for a covered security are reduced to a price below the passive market maker's bid, the passive market maker must lower its bid promptly to a level not higher than the then highest independent bid; *Provided, however,* That a passive market maker may continue to bid and effect purchases at its bid at a price exceeding the then highest independent bid until the passive market maker purchases an aggregate amount of the covered security that equals or, through the purchase of all securities that are part of a single order, exceeds the lesser of two times the minimum quotation size for the security, as determined by NASD rules, or the passive market maker's remaining purchasing capacity under paragraph (b)(2) of this section.

(4) *Limitation on displayed size.* At all times, the passive market maker's displayed bid size may not exceed the lesser of the minimum quotation size for the covered security, or the passive market maker's remaining purchasing capacity under paragraph (b)(2) of this section; *Provided, however,* That a passive market maker whose purchasing capacity at any time is between one and 99 shares may display a bid size of 100 shares.

(5) *Identification of a passive market making bid.* The bid displayed by a passive market maker shall be designated as such.

(6) *Notification and reporting to the NASD.* A passive market maker shall notify the NASD in advance of its intention to engage in passive market making, and shall submit to the NASD information regarding passive market making purchases, in such form as the NASD shall prescribe.

(7) *Prospectus disclosure.* The prospectus for any registered offering in which any passive market maker intends to effect transactions in any covered security shall contain the information required in §§ 228.502, 228.508, 229.502, and 229.508 of this chapter.

(c) *Transactions at Prices Resulting from Unlawful Activity.* No transaction shall be made at a price that the passive market maker knows or has reason to know is the result of activity that is fraudulent, manipulative, or deceptive under the securities laws, or any rule or regulation thereunder.

§ 242.104 Stabilizing and other activities in connection with an offering.

(a) *Unlawful Activity.* It shall be unlawful for any person, directly or indirectly, to stabilize, to effect any syndicate covering transaction, or to impose a penalty bid, in connection with an offering of any security, in contravention of the provisions of this section. No stabilizing shall be effected at a price that the person stabilizing knows or has reason to know is in contravention of this section, or is the result of activity that is fraudulent, manipulative, or deceptive under the securities laws, or any rule or regulation thereunder.

(b) *Purpose.* Stabilizing is prohibited except for the purpose of preventing or retarding a decline in the market price of a security.

(c) *Priority.* To the extent permitted or required by the market where stabilizing occurs, any person stabilizing shall grant priority to any independent bid at the same price irrespective of the size of such independent bid at the time that it is entered.

(d) *Control of Stabilizing.* No sole distributor or syndicate or group stabilizing the price of a security or any member or members of such syndicate or group shall maintain more than one stabilizing bid in any one market at the same price at the same time.

(e) *At-the-Market Offerings.* Stabilizing is prohibited in an at-the-market offering.

(f) *Stabilizing Levels.—(1) Maximum stabilizing bid.* Notwithstanding the

other provisions of this paragraph (f), no stabilizing shall be made at a price higher than the lower of the offering price or the stabilizing bid for the security in the principal market (or, if the principal market is closed, the stabilizing bid in the principal market at its previous close).

(2) *Initiating stabilizing.*—

(i) *Initiating stabilizing when the principal market is open.* After the opening of quotations for the security in the principal market, stabilizing may be initiated in any market at a price no higher than the last independent transaction price for the security in the principal market if the security has traded in the principal market on the day stabilizing is initiated or on the preceding business day and the current asked price in the principal market is equal to or greater than the last independent transaction price. If both conditions of the preceding sentence are not satisfied, stabilizing may be initiated in any market after the opening of quotations in the principal market at a price no higher than the highest current independent bid for the security in the principal market.

(ii) *Initiating stabilizing when the principal market is closed.*

(A) When the principal market for the security is closed, but immediately before the opening of quotations for the security in the market where stabilizing will be initiated, stabilizing may be initiated at a price no higher than the lower of:

(1) The price at which stabilizing could have been initiated in the principal market for the security at its previous close; or

(2) The most recent price at which an independent transaction in the security has been effected in any market since the close of the principal market, if the person stabilizing knows or has reason to know of such transaction.

(B) When the principal market for the security is closed, but after the opening of quotations in the market where stabilizing will be initiated, stabilizing may be initiated at a price no higher than the lower of:

(1) The price at which stabilization could have been initiated in the principal market for the security at its previous close; or

(2) The last independent transaction price for the security in that market if the security has traded in that market on the day stabilizing is initiated or on the last preceding business day and the current asked price in that market is equal to or greater than the last independent transaction price. If both conditions of the preceding sentence are not satisfied, under this paragraph

(f)(2)(ii)(B)(2), stabilizing may be initiated at a price no higher than the highest current independent bid for the security in that market.

(iii) *Initiating stabilizing when there is no market for the security or before the offering price is determined.* If no *bona fide* market for the security being distributed exists at the time stabilizing is initiated, no stabilizing shall be initiated at a price in excess of the offering price. If stabilizing is initiated before the offering price is determined, then stabilizing may be continued after determination of the offering price at the price at which stabilizing then could be initiated.

(3) *Maintaining or carrying over a stabilizing bid.* A stabilizing bid initiated pursuant to paragraph (f)(2) of this section, which has not been discontinued, may be maintained, or carried over into another market, irrespective of changes in the independent bids or transaction prices for the security.

(4) *Increasing or reducing a stabilizing bid.* A stabilizing bid may be increased to a price no higher than the highest current independent bid for the security in the principal market if the principal market is open, or, if the principal market is closed, to a price no higher than the highest independent bid in the principal market at the previous close thereof. A stabilizing bid may be reduced, or carried over into another market at a reduced price, irrespective of changes in the independent bids or transaction prices for the security. If stabilizing is discontinued, it shall not be resumed at a price higher than the price at which stabilizing then could be initiated.

(5) *Initiating, maintaining, or adjusting a stabilizing bid to reflect the current exchange rate.* If a stabilizing bid is expressed in a currency other than the currency of the principal market for the security, such bid may be initiated, maintained, or adjusted to reflect the current exchange rate, consistent with the provisions of this section. If, in initiating, maintaining, or adjusting a stabilizing bid pursuant to this paragraph (f)(5), the bid would be at or below the midpoint between two trading differentials, such stabilizing bid shall be adjusted downward to the lower differential.

(6) *Adjustments to stabilizing bid.* If a security goes ex-dividend, ex-rights, or ex-distribution, the stabilizing bid shall be reduced by an amount equal to the value of the dividend, right, or distribution. If, in reducing a stabilizing bid pursuant to this paragraph (f)(6), the bid would be at or below the midpoint between two trading differentials, such

stabilizing bid shall be adjusted downward to the lower differential.

(7) *Stabilizing of components.* When two or more securities are being offered as a unit, the component securities shall not be stabilized at prices the sum of which exceeds the then permissible stabilizing price for the unit.

(8) *Special prices.* Any stabilizing price that otherwise meets the requirements of this section need not be adjusted to reflect special prices available to any group or class of persons (including employees or holders of warrants or rights).

(g) Offerings with no U.S. Stabilizing Activities—

(1) Stabilizing to facilitate an offering of a security in the United States shall not be deemed to be in violation of this section if all of the following conditions are satisfied:

(i) No stabilizing is made in the United States;

(ii) Stabilizing outside the United States is made in a jurisdiction with statutory or regulatory provisions governing stabilizing that are comparable to the provisions of this section; and

(iii) No stabilizing is made at a price above the offering price in the United States, except as permitted by paragraph (f)(5) of this section.

(2) For purposes of this paragraph (g), the Commission by rule, regulation, or order may determine whether a foreign statute or regulation is comparable to this section considering, among other things, whether such foreign statute or regulation: specifies appropriate purposes for which stabilizing is permitted; provides for disclosure and control of stabilizing activities; places limitations on stabilizing levels; requires appropriate recordkeeping; provides other protections comparable to the provisions of this section; and whether procedures exist to enable the Commission to obtain information concerning any foreign stabilizing transactions.

(h) *Disclosure and Notification*—(1) Any person displaying or transmitting a bid that such person knows is for the purpose of stabilizing shall provide prior notice to the market on which such stabilizing will be effected, and shall disclose its purpose to the person with whom the bid is entered.

(2) Any person effecting a syndicate covering transaction or imposing a penalty bid shall provide prior notice to the self-regulatory organization with direct authority over the principal market in the United States for the security for which the syndicate covering transaction is effected or the penalty bid is imposed.

(3) Any person subject to this section who sells to, or purchases for the account of, any person any security where the price of such security may be or has been stabilized, shall send to the purchaser at or before the completion of the transaction, a prospectus, offering circular, confirmation, or other document containing a statement similar to that comprising the statement provided for in Item 502(d) of Regulation S-B (§ 228.502(d) of this chapter) or Item 502(d) of Regulation S-K (§ 229.502(d) of this chapter).

(i) *Recordkeeping Requirements.* A person subject to this section shall keep the information and make the notification required by § 240.17a-2 of this chapter.

(j) *Excepted Securities.* The provisions of this section shall not apply to:

(1) *Exempted Securities.* "Exempted securities," as defined in section 3(a)(12) of the Exchange Act (15 U.S.C. 78c(a)(12)); or

(2) *Transactions of Rule 144A securities.* Transactions in securities eligible for resale under § 230.144A(d)(3) of this chapter, if such securities are offered or sold in the United States solely to:

(i) Qualified institutional buyers, as defined in § 230.144A(a)(1) of this

chapter, or to offerees or purchasers that the seller and any person acting on behalf of the seller reasonably believes are qualified institutional buyers, in a transaction exempt from registration under section 4(2) of the Securities Act (15 U.S.C. 77d(2)) or §§ 230.144A or 230.501 through 230.508 of this chapter; or

(ii) Persons not deemed to be "U.S. persons" for purposes of §§ 230.902(o)(2) or 230.902(o)(7) of this chapter, during a distribution qualifying under paragraph (j)(1) of this section.

(k) *Exemptive Authority.* Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities.

§ 242.105 Short selling in connection with a public offering.

(a) *Unlawful Activity.* In connection with an offering of securities for cash pursuant to a registration statement or a notification on Form 1-A (§ 239.90 of this chapter) filed under the Securities Act, it shall be unlawful for any person to cover a short sale with offered securities purchased from an underwriter or broker or dealer

participating in the offering, if such short sale occurred during the shorter of:

(1) The period beginning five business days before the pricing of the offered securities and ending with such pricing; or

(2) The period beginning with the initial filing of such registration statement or notification on Form 1-A and ending with the pricing.

(b) *Excepted Offerings.* This section shall not apply to offerings filed under § 230.415 of this chapter or to offerings that are not conducted on a firm commitment basis.

(c) *Exemptive Authority.* Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities. By the Commission.

Jonathan G. Katz,
Secretary.

Dated: December 20, 1996

By: Margaret H. McFarland,
Deputy Secretary.

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