## SECURITIES AND EXCHANGE COMMISSION

## 17 CFR Parts 228, 229, 240, and 242

**[Release Nos. 33–7282; 34–37094; IC–21883; International Series Release No. 965; File No. S7–11–96]**

**RIN 3235–AF54**

## Trading Practices Rules Concerning Securities Offerings

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rules.

**SUMMARY:** The Securities and Exchange Commission (''Commission'') today is publishing for comment a new regulation containing trading practices rules governing securities offerings. Proposed new Regulation M would replace Rules 10b–6, 10b–6A, 10b–7, 10b–8, and 10b–21 under the Securities Exchange Act of 1934. Reflecting the significant developments and innovations that have occurred in the securities markets during recent years, the proposed regulation would create a simpler, more flexible framework to govern the market conduct of persons with a significant interest in the outcome of an offering. The proposals are designed to reduce regulatory burdens on issuers, underwriters, and other offering participants by focusing restrictions on potentially manipulative conduct in connection with the pricing of an offering, while retaining core investor safeguards.

**DATES:** The comment period will expire on June 17, 1996.

**ADDRESSES:** Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Comments also may be submitted electronically at the following E-mail address: rule comments@sec.gov. All comment letters should refer to File No. S7–11–96; this file number should be included on the subject line if E-mail is used. Comments letters received will be available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (http://www.sec.gov).

**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, K. Susan Grafton, Carlene S. Kim, Heidi E. Pilpel, Barbara J. Endres, John S. Markle, Lauren C. Mullen, Mark R. Pacioni, Alan J. Reed, or Marc J. Hertzberg.

**SUPPLEMENTARY INFORMATION:** The Commission is proposing for comment new Regulation M, which would be adopted under various provisions of the Securities Act of 1933 (''Securities Act''),[1] the Securities Exchange Act of 1934 (''Exchange Act''),[2] and other federal securities statutes, and would replace Rules 10b–6, 10b–6A, 10b–7, 10b–8, and 10b–21 (''trading practices rules'').[3] Proposed Regulation M, consisting of six rules, would set forth a new approach to regulation of securities offerings that reflects the incentives to affect the price of the offered security during an offering, while acknowledging the different needs of various categories of offering participants to conduct ordinary market activities. Regulation M would contain separate rules for underwriters, prospective underwriters, participating broker-dealers (''distribution participants''), and their affiliated purchasers; and for issuers and other persons on whose behalf a distribution is being made and their affiliated purchasers.[4]

The proposed rules would retain the current prophylactic approach to anti-manipulation regulation as the most effective means of protecting the integrity of the market during a securities offering. Regulation M, however, would streamline and simplify the trading practices rules by, among other things:

- Eliminating restrictions on actively-traded securities.
- Reducing the period of trading restrictions for many other securities, and focusing that period on the pricing of the offering.
- Eliminating trading restrictions on derivative securities during a distribution of an underlying security.
- Narrowing substantially the restrictions on debt securities.
- Deregulating rights offerings.
- Allowing routine dissemination of research reports, transactions in baskets of securities, exercises of call options, and transactions complying with Rule 144A under the Securities Act.[5]
- Creating a *de minimis* exception for transactions that are unlikely to have market impact.
- Narrowing the scope of persons subject to the rules.
- Allowing greater flexibility for issuer plans and odd-lot programs.
- Expanding the scope of Nasdaq passive market making.
- Creating a more flexible framework for stabilizing transactions.
- Shortening the regulated period for short sales in connection with a public offering.

### I. Introduction

#### *A. Background*

A fundamental goal of the federal securities laws is the prevention of manipulation. Manipulation impedes the securities markets from functioning as an independent pricing mechanism, and undermines the integrity and fairness of those markets. Congress granted broad rulemaking authority to the Commission to combat manipulative abuses in whatever form they might take, including anti-fraud, prophylactic, and general rulemaking authority. In exercising its authority, the Commission has focused on the market activities of persons participating in a securities offering. The Commission determined that securities offerings present special opportunities and incentives for manipulation, requiring specific regulatory attention. After developing experience in administering the general anti-fraud and anti-manipulation provisions of the Exchange Act,[6] the Commission in 1955 adopted Rules 10b–6, 10b–7, and 10b–8 to govern the market activity of persons with an interest in an offering's outcome.[7] These rules are intended to protect the integrity of the offering process by precluding activities that could influence artificially the market for the offered security.

The trading practices rules have served their purposes well. Today, the U.S. capital markets' unparalleled reputation for honesty and fairness attracts not only domestic issuers, but also an increasing number of foreign issuers that offer their securities here to gain both broader market recognition and cost-effective financing. These rules

[1] 15 U.S.C. 77a *et seq.*

[2] 15 U.S.C. 78a *et seq.*

[3] 17 CFR 240.10b–6, 240.10b–6A, 240.10b–7, 240.10b–8, and 240.10b–21. The proposed rules also would make conforming and clarifying changes to Items 502(d) and 508 of Regulation S–B and Regulation S–K, and to Rules 10b–18 and 17a–2 under the Exchange Act. 17 CFR 228.502(d), 229.502(d), 228.508, 229.508, 240.10b–18, and 240.17a–2, respectively.

[4] The term ''distribution participant,'' which is defined in proposed Rule 100 and discussed further below, has a narrower meaning than its use in the current trading practices rules.

[5] 17 CFR 230.144A.

[6] Sections 9(a)(2), 10(b), and 15(c), 15 U.S.C. 78i(a)(2), 78j(b), and 78o(c).

[7] Securities Exchange Act Release No. 5194 (July 5, 1955), 20 FR 5075.

contribute to investors' high degree of confidence that the offering price has not been influenced artificially by the conduct of offering participants.

Since the adoption of the Commission's trading practices rules over 40 years ago, and the last substantive revisions to Rule 10b–6 in the 1980s, the markets and their participants have changed significantly. Institutional investors, such as mutual funds and pension plans, have become major ''buy-side'' participants in securities offerings.[8] The market sophistication and bargaining power of such investors now provide important protections against abusive conduct on the ''sell-side'' of an offering. The secondary markets have become more transparent and trading volume has increased substantially. Increased transparency helps investors, analysts, and other market participants to better observe and evaluate unusual market price movements. Increased liquidity makes manipulation less cost-effective.

Self-regulatory organizations (''SROs'') have developed sophisticated surveillance technologies to monitor market activity on a real-time basis. The SROs' ability to surveil trading during a distribution serves a substantial deterrence function. The ready availability of transaction audit trails also enhances the Commission's and the SROs' ability to take appropriate enforcement action. As a consequence, manipulation of the actively-traded securities of large issuers has become more costly, and its success more uncertain.

The process of distributing securities also has evolved. Shelf-registered offerings have become a common method of raising capital in recent years, and equity shelf offerings are increasing.[9] Instead of engaging in formal stabilization, underwriters now routinely ''oversell'' an offering, which can result in substantial purchasing activity in the form of short covering transactions after an offering has been distributed. Today, rights offerings rarely are used as a financing tool by U.S. issuers.

Equity and debt offerings and the secondary markets have become international in scope. Many issuers' securities now are traded in financial centers throughout the world, providing issuers with expanded financing opportunities. U.S. investors are now active participants in U.S. offerings of foreign issuers. Globalization also has revealed differing, and at times conflicting, regulatory structures and offering practices.

These developments have outpaced the current structure of anti-manipulation regulation of securities offerings and have reduced the need for broad prophylactic restrictions. Moreover, the Commission has been advised by market participants that the application of the trading practices rules in the present environment has become needlessly complex and involves substantial compliance costs.

*B. Concept Release*

In April 1994, the Commission published a concept release as part of a comprehensive reexamination of its anti-manipulation regulation of securities offerings (''Concept Release'').[10] The release identified eight concepts that underlie the trading practices rules and anti-manipulation regulation generally. The premise underlying these concepts is that regulation should be limited to those persons, securities offerings, and market activities that involve a readily identifiable incentive to manipulate the market during an offering. In considering the need for a revised regulatory approach, the Commission requested that commenters focus on two central themes: whether certain classes of securities, transactions, or investors need the protection of specific rules; and whether a simpler structure for anti-manipulation regulation would achieve the goals of providing guidance to underwriters and their counsel, maintaining price integrity, establishing effective deterrence and enforcement tools, and promoting investor confidence. The Commission solicited comment on several alternative regulatory approaches.

Twenty-two comment letters were received.[11] All commenters appeared to accept the fundamental objectives of the trading practices rules of preventing manipulation during a securities offering and providing guidance to the underwriting community, principally as expressed in the exceptions to Rule 10b–6. Many commenters questioned the need for mechanical and complex proscriptive rules as opposed to a simpler, more flexible approach to anti-manipulation regulation. Of the various regulatory alternatives noted in the Concept Release, commenters addressed three: (1) Retaining the current structure, but relaxing restrictions; (2) more flexible stabilization regulation; and (3) safe harbor rules.

Many commenters proposed revising the current exceptions and adding new exceptions to the prohibitions of Rule 10b–6. Suggested approaches varied, but the dominant themes were to: shorten the period of restrictions; ease the application of the rules in multinational distributions; allow issuers greater flexibility in conducting dividend reinvestment and stock purchase plans; and narrow the scope of persons subject to restrictions.

With respect to multinational distributions, several commenters stated that extraterritorial application of the trading practices rules disadvantages U.S. participants, because foreign issuers sometimes will not engage in U.S. securities distributions that require compliance with the rules. Some commenters proposed exceptions from the trading practices rules for ''world-class'' issuers.

With respect to stabilization, commenters stated that the Commission should create a flexible structure that would allow underwriters to follow the independent market price for the offered security. Commenters also suggested that the Commission expand and adopt prior proposals to accommodate multinational stabilizing transactions. The commenters were divided, however, on whether the Commission should regulate transactions in the aftermarket of a distribution, such as the covering of syndicate short positions and the enforcing of penalty bids. Representatives of the underwriting industry argued that no regulation was warranted at this time. Other commenters asserted that certain aftermarket activity by the underwriting syndicate, such as enforcing penalty bids, can have a manipulative impact and can create conflicts of interest for broker-dealers.

Commenters also suggested that the restrictions on ''passive market making'' in Rule 10b–6A be relaxed. The few commenters who addressed Rule 10b–8 suggested that underwriters should have greater flexibility in effecting transactions during rights offerings. Two commenters stated that Rule 10b–21 was ineffectual because it did not cover securities that were related to the offered security.

[8] As of December 1995, mutual funds controlled more than $2.8 trillion in assets. See Investment Company Institute Press Release (January 25, 1996).

[9] In 1992, equity takedowns from shelf registrations accounted for 3% of all underwritten offers of additional common stock, while in 1994, equity takedowns accounted for 16% of the total value of such underwritten offerings. *See also* M. Santoli, *Block Trades Test Traditions on Wall Street,* Wall St. J., Feb. 9, 1996, at B12B (''Shelf filings that cover equity have steadily become more common in recent years, rising 18% to 110 in 1995 after climbing 26% in 1994.'')

[10] Securities Exchange Act Release No. 33924 (April 19, 1994), 59 FR 21681 (''Concept Release'').

[11] The comment letters and a summary of those comments which was prepared by the staff are available for public inspection and copying in File No. S7–14–94.

While directing the majority of their comments to specific provisions of the trading practices rules, many commenters endorsed recasting the rules as non-exclusive safe harbors from the anti-manipulation provisions of the Exchange Act.[12] In support of this proposal, they asserted that Rule 10b–6 can have a disproportionate effect on those offering participants who inadvertently run afoul of the rule's prohibitions because of ''technical'' violations that do not affect the offered security's price.

II. Overview of Proposed Regulation M

In light of the comments received and the recommendations of the Commission's Task Force on Disclosure Simplification, the Commission is proposing to replace the existing trading practices rules with new Regulation M, consisting of individual rules covering distinct categories of offering participants and activities.[13] The new regulation would continue to effectuate the goals of the existing trading practices rules. The Commission, however, recognizes that the current rules impose unwarranted costs on the capital raising process because they are overly broad and unnecessarily rigid.

The Commission's proposals seek to accomplish several objectives. The proposed rules are intended to eliminate unnecessary costs and burdens imposed on offering participants under the current rules. These impediments would be reduced by relaxing existing restrictions in those circumstances where either the risk of manipulation appears small or the costs of the restrictions are disproportionate to the purposes that they serve. For example, relaxation of restrictions seems particularly appropriate in cases where the expense of manipulating a security would be high or where improper trading activity would be easy to detect, because the risk of manipulation in such situations may be far less than in other offerings.

The proposed rules also seek to simplify and modernize the trading practices rules. These goals are accomplished by reorganizing the structure of the rules, reducing their complexity, and tailoring the concepts to accommodate contemporary market activities.

Regulation M would contain rules covering the following activities during a securities offering: (1) Activities by underwriters, prospective underwriters, brokers, dealers, or other persons who are participating in a distribution, and their affiliated purchasers (*i.e.*, distribution participants); (2) activities by the issuer or selling securityholder 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. 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 Rule 10b–5 thereunder, would continue to govern all activities in connection with an offering, whether or not the provisions of Regulation M applied.

A separate rule would contain 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 would be contained in Rules 101 and 102, which would cover distribution participants, and issuers and selling securityholders, respectively. Rules 101 and 102 would apply only during a ''restricted period'' that would commence one or five business days before the day of the pricing of the offered security and continue until the distribution is over. The restricted periods would be based on the trading volume of the offered security, rather than the price per share and public float criteria used in Rule 10b–6. The restricted periods of Regulation M would focus more specifically on the time of pricing. In contrast, Rule 10b–6 imposes restrictions during the entire distribution, which can extend over a lengthy period of time, but excepts certain trading activities prior to a two or nine business day ''cooling-off period.'' The applicable cooling-off period is keyed off of the commencement of offers and sales. While Rule 10b–6 is intended to protect the pricing of an offering, certain distribution methods, particularly in connection with foreign offerings, can result in the cooling-off periods commencing after an offering has been priced.

Rule 101 would exclude from its coverage more actively-traded securities, many investment grade securities, and Rule 144A transactions. Further, Rule 101 would focus on the security being distributed and would not cover related derivative securities. It would permit the routine dissemination of research reports, exercises of options and other securities, and transactions in baskets of securities involving the offered security, among other transactions. In addition, Rule 101 would deal with ''inadvertent'' violations during the restricted period by excusing *de minimis* transactions, provided that a distribution participant had in place policies and procedures reasonably designed to achieve compliance with the rule. The scope of persons subject to the proposed rule would be narrowed by recognizing ''information barriers'' between the distribution participant and its affiliates.

Rule 102 would cover issuers, selling securityholders, and related persons. Issuers and selling securityholders would be able to engage in market activities prior to the applicable restricted period. During the restricted period, Rule 102 would permit 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. This rule would not contain an exception for actively-traded securities. The proposals also would reflect the view that the safe harbor of Rule 10b–18 under the Exchange Act is not available during a distribution.[14]

Proposed Rule 103 would govern Nasdaq passive market making and replace Rule 10b–6A. The new rule would extend to all Nasdaq securities and nearly all distributions, and would permit more distribution participants to engage in passive market making.

Proposed Rule 104 would regulate stabilizing and other activities related to a distribution. The rule would allow 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 did not exceed the offering price. Rule 104 also would address the fact that underwriters engage in substantial syndicate-related market activity, and enforce penalty bids in order to reduce volatility in the market for the offered security. These activities are analogous to traditional stabilizing under Rule 10b–7. The proposed rule would require disclosure and recordkeeping with respect to these aftermarket activities.

Proposed Rule 105 essentially would recodify 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 would be narrowed to the five business day

[12] The American Bar Association (''ABA'') and the Securities Industry Association drafted proposed rule texts for the staff's consideration, which are included in File No. S7–14–94.

[13] *See Report of the Task Force on Disclosure Simplification* 77–79 (March 1996) (''Task Force Report'').

[14] 17 CFR 240.10b–18.

period before pricing, rather than the period extending from the time of filing of offering materials to the time when sales may be made. This release requests comment, however, on the continued need for a separate rule regulating such short selling.

The Commission believes that separate regulation of rights offerings, as contained in Rule 10b–8, may no longer be warranted. U.S. issuers infrequently use rights offerings to raise capital. Even when they do, purchases of rights generally would not be an efficient way for a distribution participant to facilitate the offering of the underlying security. In addition, the Commission believes that many rights offerings by foreign issuers would fall within the exception for actively-traded securities contained in Rule 101. Therefore, the proposals would rescind Rule 10b–8.

The proposed trading practices rules, like the current rules, would apply to all distribution participants in a multinational offering of securities, as well as the issuer and any selling securityholders or affiliated purchasers, if the offering occurs at least in part in the United States. In connection with the Concept Release, as noted above, several commenters addressed the application of the trading practices rules to multinational offerings. Regulation M would not distinguish between domestic and multinational offerings subject to the Commission's regulatory jurisdiction. Nevertheless, the proposed rules respond to the concerns of these commenters. In particular, the exceptions to Rule 101 for actively-traded securities, and the exclusion of affiliates of distribution participants where the distribution participant maintains and enforces certain information-flow restrictions, should facilitate the ability of issuers and underwriters to conduct multinational offerings.

Many terms and concepts in Regulation M would have the same meaning as under the trading practices rules (*e.g.*, the definition of ''distribution''), and current interpretations regarding such terms or concepts would be relevant to the new rules. Exemptions granted and no-action positions taken under the current rules no longer would be in effect under Regulation M because the rules under which they were issued would be rescinded. Many of these exemptions and no-action positions, however, are proposed to be codified and, in many cases, expanded under the new rules. Others no longer would be necessary in view of the provisions of the new rules. The Commission believes that the broad scope of these amendments will greatly reduce the need for the issuance of exemptions from the proposed rules. In reviewing the proposals, commenters are urged to consider their implications for existing exemptions, no-action positions, and interpretations.

The new regulatory framework should relieve market participants of unnecessary burdens and respond effectively to a changing marketplace, while maintaining essential investor protection. The following sections of this release describe the individual provisions of Rules 100 through 105 and discuss, where appropriate, how they would differ from current anti-manipulation regulation and why the Commission is proposing such changes. Comment is solicited throughout the release regarding specific aspects of the proposals. In addition to responding to these questions, commenters are encouraged to state how the proposed rules either would or would not accomplish the goals of Regulation M.

## III. Discussion of Proposed Regulation M and Related Amendments

### *A. Rule 100—Definitions*

Proposed Rule 100 would set forth the definitions that apply to all of the rules contained in Regulation M. Many of the terms in Rule 100 are defined in the trading practices rules, although the definitions of some of these terms have been revised to reflect commenters' suggestions. The Commission also proposes to codify terms that have been used in interpretations, or are the subject of outstanding Commission proposals.[15] Other terms are new, and are integral to the fundamental changes that are reflected by Regulation M. Individual definitions are discussed later in this release in connection with the particular aspects of Regulation M to which they relate.

Q1. Do any of the definitions need to be clarified or modified? Are there other terms used in Regulation M that should be defined in Rule 100?

### *B. Rule 101—Activities by Distribution Participants*

#### 1. Overview of Rule 101

This proposed rule would include significant similarities to as well as differences from Rule 10b–6. Rule 101, like Rule 10b–6, would place restrictions on the activities of distribution participants and their affiliated purchasers during the distribution period.[16] However, while Rule 10b-6 applies during the entire distribution period, which extends from the time the issuer determines to go forward with the offering until all sales efforts end, the rule contains exceptions permitting certain transactions until the commencement of cooling-off periods. In contrast, Rule 101 would apply only during the period commencing one or five business days immediately preceding pricing of the offering and ending when sales efforts cease.

Both Rule 101 and Rule 10b–6 cover securities that are the subject of the distribution. Rule 101 would not apply to any security with an average daily trading volume (''ADTV'') with a value of $1 million or more, or to any related derivative securities. Rule 101, however, would apply to transactions in an underlying security (*i.e.*, a ''reference security'') during a distribution of a derivative security.

Rule 101 and Rule 10b–6 apply to distribution participants and their affiliated purchasers. For purposes of Rule 101, ''distribution participant'' would refer to underwriters, prospective underwriters, brokers, dealers, and other persons who have agreed to participate or are participating in a distribution. Issuers and selling securityholders and their affiliated purchasers, which also are covered by Rule 10b–6, would be subject to proposed Rule 102. The definition of ''affiliated purchaser'' would be narrower than that contained in Rule 10b–6, and would recognize the use of information barriers to separate distribution participants' corporate financing activities from the trading operations of their affiliates.

Rule 101 would contain exceptions from its proscriptions for activity that is necessary to permit the offering to proceed; to limit adverse effects on the trading market that could result from these prohibitions; and to allow conduct that is not likely to have a manipulative impact.

Moreover, the Commission has simplified the language used in Rule 101, and believes that the proposed rule reflects the broader sources of statutory authority under which Regulation M would be adopted, including the anti-fraud provisions, the statutory authority to adopt ''means reasonably designed to prevent'' fraud and manipulation, and the Commission's general rulemaking authority. Rule 101 explicitly would include a prohibition against inducing

[15] See Securities Exchange Act Release No. 28732 (January 3, 1991), 56 FR 814 (proposing amendments to Rule 10b–7); Securities Exchange Act Release No. 28733 (January 3, 1991), 56 FR 820 (proposing definitional Rule 3b–10) (collectively, ''1991 Proposals''). These proposals would be withdrawn upon adoption of Regulation M.

[16] The definition of ''distribution'' for purposes of Rule 101 would be identical to that contained in Rule 10b–6.

others to bid for as well as purchase any covered security.

2. Securities Excepted From Rule 101

a. Securities With an ADTV Value of $1,000,000 or More

Commenters on the Concept Release supported the idea of reducing restrictions on actively-traded foreign and U.S. securities consistent with the principles of the Commission's 1993 Statement of Policy.[17] After considering commenters views and the Commission's experience with the Statement of Policy, the Commission is proposing to exclude from Rule 101 all securities with a published ADTV value of at least $1 million.[18] Thus, proposed paragraph (c)(1) of Rule 101 would eliminate the requirement of Rule 10b–6 that distribution participants and their affiliated purchasers restrict market activities in these securities and related securities. This action would enhance significantly cross-border capital raising capabilities because, for many foreign issuers, the trading practices rules have been an impediment to offering their securities in the United States.

The Commission preliminarily believes that it is reasonable to remove prophylactic trading restrictions for securities with a minimum ADTV value of $1 million and to rely on market mechanisms to curb manipulative activity.[19] While the price of any security can be manipulated, the Commission is of the view that, as the value of trading volume of a security increases, it becomes less likely that a distribution participant would be able, cost-effectively, to affect the price of the security. Actively-traded securities generally are followed widely by the investment community, and aberrations in price are likely to be observed and corrected quickly. Moreover, virtually all actively-traded securities are traded on exchanges or other organized markets with high levels of transparency and surveillance.[20]

If adopted, it is estimated that the $1 million value of ADTV threshold would remove from Rule 101 equity securities of over 2,000 domestic issuers and a substantial number of foreign securities.[21] The Commission believes that this threshold will except a large group of securities as to which the potential for a successful manipulation is more limited. This will make it easier for both foreign and domestic issuers to access the U.S. capital markets, and will afford more opportunities for U.S. investors.

The proposed exception would not compromise investor protection because the general anti-fraud and anti-manipulation provisions would continue to apply to offerings of these securities. Those provisions would continue to prohibit distribution participants and their affiliated purchasers from influencing a security's price as a means to facilitate a distribution.

Q2. Is the exception for actively-traded securities appropriate? Is the ADTV threshold of $1 million appropriate? Should the threshold be $5 million or some other level? Commenters suggesting another threshold should provide reasons to support their views.

Q3. Should transactions by distribution participants in actively-traded securities be restricted for a brief period (*e.g.*, one or two hours) prior to pricing? Would such a restricted period be feasible to implement?

In the case of distributions of certain actively-traded foreign securities, the Commission has not applied Rule 10b–6 to transactions in securities markets that have not represented a significant proportion of activity in the security, *i.e.*, where the trading volume in a particular jurisdiction accounts for less than 10% of the aggregate worldwide published trading volume in the security (''non-significant markets'').[22] The Commission is not proposing an exclusion for transactions effected in non-significant markets because the proposed exception for actively-traded securities would permit transactions in those securities without restriction. The concept of non-significant markets, however, may be important if a brief restricted period were required for actively-traded securities, or for those offerings of foreign securities that are subject to Rule 101.

Q4. Should transactions effected in non-significant markets be subject to restricted periods? How would non-significant markets be defined (*e.g.*, would the current test of less than 10% of aggregate worldwide published trading volume suffice)? Commenters favoring an exception for transactions in non-significant markets should discuss the context where the principal market is closed for trading.

Although the Commission is not proposing to include a specific disclosure or recordkeeping requirement for transactions in these securities by distribution participants, as contained in exemptions issued pursuant to the Statement of Policy, the Commission is proposing amendments to Regulations S–B and S–K that would require disclosure of syndicate covering transactions and penalty bids that could affect an offered security's price.[23]

Q5. Should the disclosure requirements referenced in the Statement of Policy apply to transactions in actively-traded securities excepted from Rule 101?

b. Investment Grade Nonconvertible Securities

Paragraph (c)(2) of Rule 101 generally would incorporate the exception contained in Rule 10b–6(a)(4)(xiii), which excepts nonconvertible debt securities and nonconvertible preferred securities, if the nonconvertible securities being distributed are rated investment grade by at least one nationally recognized statistical rating organization (''NRSRO''). This exception is based on the premise that these securities are traded on the basis of their yields and credit ratings, rather than the identity of the particular issuer, are largely fungible and, therefore, are less likely to be subject to manipulation.[24]

Q6. Do investment grade asset-backed securities have the same characteristics, including with respect to trading, as nonconvertible investment grade debt securities of corporate issuers? Should investment grade asset-backed securities be excepted from Rule 101?

[17] *See* Securities Exchange Act Release No. 33137 (November 3, 1993), 58 FR 60324 (''Statement of Policy''). *See also Letter regarding Exemptions from Rules 10b–6, 10b–7, and 10b–8 During Distributions of Certain German Securities,* Securities Exchange Act Release No. 33022 (October 6, 1993), 58 FR 53220; *Letter regarding Distributions of Certain French Securities,* Securities Exchange Act Release No. 34176 (June 7, 1994), 59 FR 31274; *Letter regarding Exemptions from Rules 10b–6, 10b–7, and 10b–8 During Distributions of Certain United Kingdom Securities and Certain Securities Traded on SEAQ International,* Securities Exchange Act Release No. 35234 (January 11, 1995), 60 FR 4644; *Letter regarding Exemptions from Rules 10b–6, 10b–7, and 10b–8 During Distributions of Certain Dutch Securities,* Securities Exchange Act Release No. 36412 (October 19, 1995), 60 FR 55391.

[18] A $5 million ADTV threshold was used in the Statement of Policy as well as in the class exemptions issued thereunder to identify very actively-traded securities. *See supra* note 17.

[19] *See infra* Section III.B.3.b. for a discussion of ADTV generally.

[20] The Commission expects that SROs will continue to enhance their systems and procedures to capture improper trading during distributions.

[21] Based on transaction information for 1994, approximately 1,051 securities listed on the New York Stock Exchange, Inc. (''NYSE''), 677 securities quoted on Nasdaq, and 30 securities listed on the American Stock Exchange, Inc. (''AMEX'') would be excluded from the rule. In 1994, firm commitment public offerings were conducted for 268 of these securities. The general increase in security prices and trading volume since year-end 1994 would increase the number of securities likely to be excluded from the proposed rule.

[22] *See supra* note 17 (citing class exemptions).

[23] *See infra* Section III.E.5.

[24] Securities Exchange Release No. 19565 (March 4, 1983), 48 FR 10628, 10631–32 (''Release 34–19565'').

Q7. For purposes of Rule 101, should an exception for nonconvertible investment grade debt or preferred securities be based on criteria other than a rating by an NRSRO?

c. Exempted Securities

The Commission proposes to exclude from Rule 101 ''exempted securities,'' as defined in Section 3(a)(12) of the Exchange Act. Rule 10b–6 provides an exception for these exempted securities, and also specifically excludes securities that are issued, or guaranteed as to principal and interest, by the International Bank for Reconstruction and Development (''IBRD''). The Commission believes that the exception for nonconvertible investment grade debt makes it unnecessary to refer to securities of the IBRD, or of any other entity, within the ''exempted securities'' exception.

d. Face-Amount Securities or Securities Issued by an Open-End Management Investment Company or Unit Investment Trust

The Commission proposes to except from Rule 101 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 pursuant to paragraph (c)(4) of Rule 101. Paragraph (d) of Rule 10b–6 contains such an exception.

3. Securities and Activities Covered by the Rule

a. Restricted Periods

In the Concept Release, the Commission requested comment on whether the Rule 10b–6 cooling-off periods, and the criteria used to determine such periods, should be revised. Nine commenters addressed these issues. These commenters supported shortening the cooling-off periods, asserting that the two and nine business day periods no longer are justified, especially in light of advances in the SROs' surveillance systems and enhanced market transparency. A few commenters stated that the price and public float criteria should be replaced and suggested tests based on trading volume, market capitalization, or public float.

In Rule 10b–6, a security with a per share price of at least $5.00 and a public float of at least 400,000 shares has a cooling-off period of two business days, while all other securities are subject to a nine business day cooling-off period. The Commission adopted these criteria because a security's public float provided a reasonable indication of the depth and liquidity of the market for a security; a minimum share price criterion was appropriate in light of the generally greater volatility of lower priced stocks; and the criteria were easily ascertainable.[25] In addition, a five business day cooling-off period applies to the exercise of standardized call options that were acquired after the person became a distribution participant.

For securities covered by Rule 101 (*i.e.*, those with a published ADTV value of less than $1,000,000), the Commission is proposing to replace the existing cooling-off periods with two shorter restricted periods:

i. for a security with a published ADTV value equal to or exceeding $100,000, the restricted period would begin on the later of *one business day* prior to the determination of the price of the security to be distributed, or such time that a person becomes a distribution participant, and end upon the completion of such person's participation in the distribution of a security;[26]

ii. for all other securities, the restricted period would begin on the later of *five business days* prior to the determination of the price of the security to be distributed, or such time that a person becomes a distribution participant, and end upon the completion of such person's participation in the distribution.

Accordingly, the proposed trading restrictions of Rule 101 focus on a security's ADTV value, and the period immediately before the offering is priced. This approach differs from the cooling-off periods under Rule 10b–6, which are based on the price and public float of a security and begin prior to the commencement of offers and sales in the distribution.

The Commission believes that the proposed thresholds effectively balance maintaining depth and liquidity in the period immediately preceding pricing and protecting the integrity of the market as an independent pricing mechanism. Many securities now qualifying for a two business day cooling-off period and some nine business day securities would have this period reduced to one business day. For a large number of securities, the nine business day period would be reduced to five business days. The applicable period for some securities would increase from two to five business days.[27]

Q8. Would the proposed restricted periods adequately balance the goal of maintaining market liquidity with the mandate to protect investors from manipulation? If not, should one hour be used rather than one business day? Should two or nine business days continue to be used rather than one and five business days?

In some offerings, there is a lag between the time that the securities are priced and the commencement of sales. For example, in certain foreign offerings, the securities are priced, then there is a subscription period for home-country residents, after which international offers commence. Similarly, in the case of an exchange offer or merger, the securities could be priced some time before the exchange offer or proxy solicitation period commences. In these offerings, as in other distributions, the Commission believes that the restricted periods should apply one or five business days prior to the pricing of the offering and continue until distribution activities terminate. Thus, there could be a period of time between pricing and the commencement of offers and sales when market activity by distribution participants and their affiliated purchasers would be restricted by Rule 101.

Q9. Are there circumstances when the application of the restricted periods should be modified? For example, should there be a separate restricted period in the case of merger transactions or exchange offers? Commenters should describe situations where they believe that a restricted period based on pricing may not be feasible.

b. The Use of a Test Based on ADTV

As indicated above, the basis for determining which restricted period applies to a particular security would be different from the test used for the cooling-off periods under Rule 10b–6. Various measurements could be used to provide relatively certain and easily determinable criteria for applying the appropriate restricted period (*e.g.*, ADTV value, the security's price, an issuer's public float). For purposes of Regulation M, the Commission believes that the value of a security's ADTV is the most appropriate test because it provides a more accurate indication of

[25] See Release 34–19565, 48 FR at 10634.

[26] The term ''business day'' would be defined in Rule 100 as a 24 hour period, determined with reference to the principal market for the security to be distributed, that includes a complete trading session for that market.

[27] Compared with the cooling-off periods under the current rule, for 7,477 NYSE, AMEX, and Nasdaq securities, approximately 24% will not be subject to Rule 101, approximately 56% will have a shorter restricted period, and approximately 20% will have a longer restricted period (based on 1994 price and volume information).

the depth and liquidity of the trading market for a security than its price and public float. For example, although an issuer may have a significant public float, the dollar value of daily trading in its common stock may be quite low.

The Commission proposes to define ''average daily trading volume'' as the world-wide reported average daily trading volume during the three full consecutive calendar months immediately preceding either the date of the filing of the registration statement, or if there is no registration statement or if the distribution involves a shelf takedown, three full consecutive calendar months immediately preceding the pricing. To determine the value of the ADTV, it is proposed that the ADTV either be multiplied by the security's price (in dollars) as of the last business day of the most recent month, or calculated by using the actual price and volume information for each day within the three month period, if it is available.

Q10. Does the value of a security's ADTV provide the appropriate standard on which to base the restricted periods? Should a test based on the issuer's public float be used instead? If so, should the thresholds be, for example, a $150 million public float for the actively-traded securities exception; a public float of $25–$150 million for the one business day restricted period; and a public float of below $25 millon for the five business day restricted period?

Q11. Is information on ADTV readily available to participants in a distribution?

Q12. Should ADTV be based on a different measuring period, *e.g.*, 12 full calendar months, or a rolling three month (*i.e.*, 90 day) period, rather than three full calendar months?

c. Derivative Securities

The Concept Release stated the Commission's view that anti-manipulation regulation of securities offerings ''should be limited to securities whose prices may significantly affect the market's evaluation of a security in distribution.'' [28] Rule 10b–6(a)(4) applies to: (1) The security being distributed, (2) any security of the ''same class and series'' as that security, and (3) ''any right to purchase'' any such security. In the case of distributions of a security that is ''immediately exchangeable for or convertible into'' another security, or that entitles the holder immediately to acquire another security, Rule 10b–6(b) also prohibits purchases of the other security.

The ''right to purchase'' and ''same class and series'' concepts appear to be both too broad and too limited. The same class and series language has been construed broadly to encompass similar securities of an issuer even though there is no inherent mathematical relationship between the prices of those securities.[29] This has led to some complicated and not very clearly defined distinctions in applying the rule to offerings of debt. On the other hand, the right to purchase concept has been interpreted so as not to reach securities that are not ''immediately'' convertible into each other. These securities, however, trade with a price relationship to the security in distribution because their ultimate value is, or in the future may be, determined by the value of the security into which they are exchangeable or exercisable.[30] The concept also does not encompass a wide variety of securities that have been developed in recent years whose value is or will be derived from another security, but that do not give the holder the right to acquire that security. On the other hand, Rule 10b–6 applies to transactions in derivative securities, such as options and warrants, that are exchangeable or exercisable for the security in distribution, but are not very efficient vehicles to cause a price effect on the distribution security.

The Commission is proposing to eliminate these two Rule 10b–6 concepts, and to apply the trading restrictions of Rule 101 to ''covered securities,'' which would include the security in distribution and ''reference securities.'' A ''reference security'' would be defined in Rule 100 as a security whose price is or will be used to determine, in whole or in significant part, the price of another security that is the subject of a distribution.[31]

In contrast, derivative securities related to the security in distribution would not be covered by the rule. The Commission believes that the manipulative potential of trades in a derivative security for the purpose of affecting the price of an underlying security is sufficiently attenuated such that these securities should not be covered by Regulation M. Thus, for example, bids or purchases of the underlying common stock (*i.e.*, the reference security) would be restricted during a distribution of a security exercisable or exchangeable for, or convertible into, the common stock. On the other hand, bids or purchases of any exercisable, exchangeable, or convertible security would not be restricted during a distribution of the related common stock.

Many securities that under Rule 10b–6 are deemed by interpretation to be of the same class and series as those distributed, because of the similarities in their coupon rates, maturity dates, and other provisions, would not be subject to Rule 101. For example, Rule 101 would not apply to bids for and purchases of nonconvertible debt or preferred securities of the same issuer that are not identical in their principal features to the securities being distributed. The Commission preliminarily believes that the benefit of reducing compliance costs and maintaining a normal trading market for these other securities outweighs the possibility that bids for and purchases of such securities could be used to facilitate a distribution. Rule 101 would apply, however, to transactions in securities that differ from a security in distribution only as to the presence or absence of voting rights.

Q13. Commenters are invited to discuss whether derivative securities, *i.e.*, those that derive all or part of their value from a security in distribution, should be covered by Regulation M.

Q14. Is there a more appropriate definition for a ''reference security?''

Q15. Should a security that could never contribute more than 5% of the value of another security not be deemed to be a reference security for that security? If derivative securities are covered by the rule, are there feasible means to identify securities with a price relationship to a security in distribution that is sufficiently attenuated that it should not be covered by the rule? For example, should a derivative security that derives less than 5% of its value from a security in distribution be excluded?

4. Distributions

a. Definition of Distribution

In the Concept Release, the Commission sought comment on whether to continue to define the term ''distribution,'' and if so, whether the term's definition should continue to be based on the ''magnitude of the offering'' and the presence of ''special

[28] Concept Release, 59 FR at 21688.

[29] *See* Concept Release, 59 FR at 21688. *See also Letter regarding Gamble-Skogmo, Inc.* (January 11, 1974).

[30] *See* Release 34–19565, 48 FR at 10634 n.28.

[31] Examples of securities that are not covered expressly by Rule 10b–6, but would be covered by Rule 101 as reference securities, include the underlying common stock during distributions of ''preferred equity redemption cumulative stocks'' (''PERCS'') and ''equity-linked notes'' (''ELNS'').

selling efforts and selling methods.''[32] Commenters did not suggest any changes to the definition or that it be eliminated from the rule. Accordingly, the term ''distribution'' for purposes of Regulation M is proposed to have the same meaning as in Rule 10b–6. The Concept Release sought comment on whether certain types of offerings, specifically, mergers and exchange offers, should continue to be deemed distributions. Few comments, however, were received on this issue. Thus, the Commission does not propose excluding mergers and exchange offers from the definition of distribution.[33]

Q16. Does the definition of distribution continue to be appropriate?

b. Shelf Offerings

The Commission believes that it is useful to discuss the proposed application of Rules 101 and 102 in the particular context of shelf offerings. In 1983, the Commission permanently adopted Rule 415, which, among other things, allows issuers and selling shareholders to register securities for sale on a delayed or continuous basis.[34] Since the Commission last addressed this issue, the methods by which shelf offerings are conducted have changed, and the use of shelf registration has increased. For example, ''unallocated'' shelf registration statements that register a substantial amount of securities, but do not specify the exact amounts of particular types of securities that may be sold, have become more common. The Commission believes that it is appropriate to reflect these developments in the treatment of shelf offerings for purposes of proposed Rules 101 and 102.

Under a current Commission interpretation, ''any shelf-registered offering that constitutes a Rule 10b–6 distribution should be considered a single distribution for purposes of the rule.''[35] This means that once an issuer, or a selling securityholder that is in a control relationship with the issuer, determines to proceed with a shelf registered distribution, each takedown off of the shelf is subject to Rule 10b–6 irrespective of its individual magnitude.[36] However, a selling securityholder that is not an affiliated purchaser of the issuer or of any other selling securityholder is subject to the restrictions of Rule 10b–6 only with respect to offers or sales of that individual securityholder's securities.[37]

In addition, under Rule 10b–6, the Commission has distinguished between broker-dealers that have arrangements, agreements, or understandings with issuers to sell all or a portion of the securities being distributed off the shelf (''continuing agreements''), and those that do not. If a broker-dealer has a continuing agreement with an issuer to sell, from time to time, securities registered on the shelf, it is subject to the full cooling-off period prior to any offer or sale off the shelf. If a broker-dealer does not have a continuing agreement with an issuer, and decides to submit a bid in response to an issuer's solicitation of interest in purchasing its securities for distribution, the broker-dealer is subject to the applicable cooling-off period from the time that it decides to submit the bid.[38] If a broker-dealer submits an unsolicited bid, it is not deemed to be a participant until the bid has been accepted or the broker-dealer has reason to believe that it will be accepted.[39]

Rather than applying the single distribution position, the Commission would take a modified approach regarding the application of Rule 101 to shelf distributions.[40] Under the Commission's proposed approach, rather than considering the entire shelf to be a single distribution and applying the rule's restricted periods to any offers or sales off the shelf, each takedown would be examined individually in order to determine whether such offering constitutes a distribution, *i.e.*, whether it satisfies the ''magnitude'' and ''special selling efforts and selling methods'' criteria of a distribution.[41]

A broker-dealer participating in the offering of a shelf tranche should determine whether it is participating in a ''distribution.'' To determine the magnitude of the offering for purposes of Rule 101, the broker-dealer would have to assess the amount of securities that it is, or foreseeably will be, asked to sell.[42] The broker-dealer also would need to analyze the selling efforts and selling methods that it will use. For example, where a broker-dealer sells shares on behalf of an issuer or selling securityholder in ordinary trading transactions into an independent market, *i.e.*, without any special selling efforts, the broker-dealer is not subject to Rule 10b–6.[43] Special selling efforts likely would be involved, however, where a broker-dealer enters into a sales agency agreement that provides that it will receive unusual transaction-based compensation for the sales, even if the securities are sold in ordinary trading transactions. An issuer's identification in a shelf registration statement of a variety of potential selling methods that could be used to sell registered securities off a shelf (some of which would constitute ''special selling efforts''), however, would not, in itself, require a broker-dealer to consider itself to be involved in a distribution unless special selling efforts or methods were used by the broker-dealer in connection with particular sales off the shelf.[44]

[32] A distribution is defined in Rule 10b–6(c)(5) as ''an offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.''

[33] The Commission is of the view that exchange offers and mergers involving the issuance of securities, and related shareholder election and valuation periods, should be subject to Regulation M. *See Georgia-Pacific Corporation*, SEC Litigation Release No. 3511, (May 23, 1966). *See also* Release 34–19565, 48 FR at 10638 n.61.

Because the Commission is proposing to eliminate the ''right to purchase'' concept, Rule 10b–6 restrictions on purchases of most target company securities during an exchange offer or a merger involving the issuance of securities would be eliminated. Rule 10b–13 under the Exchange Act, however, would continue to prohibit any purchases or arrangements to purchase target securities, or a security immediately convertible into or exchangeable for those securities, from the time of public announcement until the expiration of a tender or exchange offer. 17 CFR 240.10b–13.

[34] 17 CFR 230.415. Securities Exchange Act Release No. 20384 (November 17, 1983), 48 FR 52889.

[35] Release 34–19565, 48 FR at 10631. This has been known as the ''single distribution position.''

[36] *Id. See also* Securities Exchange Act Release No. 23611 (September 11, 1986), 51 FR 33242, 33244 (''Release 34–23611'').

[37] Release 34–23611, 51 FR at 33244.

[38] *See* Release 34–19565, 48 FR at 10634.

[39] *See id.* at 10635. *See also infra* Section III.B.5.b. discussing the revised definition of ''prospective underwriter.''

[40] The Commission's revised interpretation regarding shelf offerings would apply to distribution participants, issuers, and selling securityholders, and would modify previous Commission interpretations regarding shelfs. *See* Release 34–23611, 51 FR at 33244–45.

[41] If a distribution participant (*e.g.*, a broker-dealer) has not entered into a continuing agreement with an issuer or selling securityholder, and if the sales off the shelf constitute a distribution, then the distribution participant would be required to comply with Rule 101 from the later of the applicable restricted period for the offered security, or the time that such person becomes a distribution participant. This interpretation reflects the speed with which sales off a shelf frequently occur.

[42] If sales off a shelf by an issuer, or by any affiliated purchaser of the issuer, constitute a distribution of securities, the issuer and all issuer affiliated purchasers would be subject to the applicable restricted period of Rule 102. Similarly, if any shelf securityholder is selling securities off a shelf, and such sales constitute a distribution, all other shelf securityholders who are affiliated purchasers of the selling securityholder would be subject to the applicable restricted period of Rule 102. *See* Release 34–23611, 51 FR at 33245.

[43] *See* Release 34–23611, 51 FR at 33247.

[44] *Cf.* Securities Exchange Act Release No. 18528 (March 3, 1982), 47 FR 11482, 11485 (''Release 34–18528''). Under current interpretation, if a registrant, when disclosing its proposed plan of distribution, reserves the right to utilize techniques that might entail selling efforts or compensation of the type normally associated with a distribution,

Continued

Q17. Should a broker-dealer that enters into a continuing agreement regarding sales of all securities or a significant amount of the shares on the shelf be viewed differently from one whose participation is limited to a single takedown?

Q18. Are there other issues raised by the application of Rule 101 to shelf offerings that the Commission should address?

5. Persons Subject to the Rule

a. Distribution Participant

The term ''distribution participant'' is proposed to be defined in Rule 100 as an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in the distribution.

Q19. Does the proposed definition of distribution participant adequately cover those persons, other than an issuer or selling securityholder, who have a readily identifiable incentive to manipulate the market during an offering? [45]

b. Prospective Underwriter

Commenters requested that the Commission provide greater certainty as to when a person becomes a ''prospective underwriter'' for purposes of Rule 10b–6.[46] Commenters were concerned especially with the application of this definition in the context of shelf-registered distributions when a broker-dealer has submitted a bid to purchase shelf-registered securities, but does not know whether the bid will be accepted by the issuer or selling securityholder. This uncertainty may exist in those circumstances where bids are submitted to the issuer or selling securityholder by a number of broker-dealers, or where the issuer or selling securityholder solicits a bid from a broker-dealer, but has not indicated an intention to offer shares off the shelf or to select that particular broker-dealer as an underwriter.

The Commission believes that the definition of ''prospective underwriter'' should reflect the principle that anti-manipulation regulation should apply when there exists an incentive to manipulate.[47] In the Commission's view, a person has an incentive to manipulate, and thus becomes a prospective underwriter, when such person knows or reasonably expects that a bid or proposal it has submitted to the issuer or selling securityholder will be accepted, whether or not the underwriting's terms and conditions have been agreed upon. Moreover, a person who has received an invitation to participate in an offering should be deemed a ''prospective underwriter'' from the time that the person decides to participate, whether or not that decision has been communicated to the issuer, selling securityholder, or managing underwriter.

Accordingly, Rule 100 would define ''prospective underwriter'' as a person who: (i) has submitted a bid to the issuer or other person on whose behalf the distribution is to be made, which such person knows or reasonably expects will be accepted, whether or not the terms and conditions of the underwriting have been agreed upon; or (ii) has reached, or reasonably expects to reach, an understanding with the issuer or selling shareholder, or with the managing underwriter, that such person will become an underwriter, whether or not the terms and conditions of such person's participation have been agreed upon.

A broker-dealer would be subject to Rule 101 beginning with the commencement of the restricted period or such later time as the broker-dealer becomes an underwriter or prospective underwriter. If the broker-dealer has a continuing agreement with the issuer or selling securityholder, such firm would have advance knowledge that the distribution will take place. Thus, the broker-dealer would be required to observe the entire restricted period prior to the pricing of the offered security subject to that agreement. There may be other scenarios where a broker-dealer does not have a continuing relationship with an issuer, but would be in a position to have advance knowledge that a takedown off a shelf will occur and that the broker-dealer will participate in the distribution. Such broker-dealer also would be required to observe the entire restricted period. This position reflects the role that such broker-dealers generally play in advising issuers and selling shareholders regarding the timing of shelf offerings.

Q20. Does the proposed definition of prospective underwriter provide sufficient flexibility and certainty to persons who submit bids to become underwriters of securities?

c. Affiliated Purchaser

Certain persons who are not themselves distribution participants have relationships with distribution participants that raise concerns that they may have incentives to facilitate a distribution through manipulative means. These persons are referred to in Rule 10b–6 and in Regulation M as ''affiliated purchasers.'' Both Rule 10b–6 and Rule 100 include within this term: (1) persons who act in concert with a distribution participant in connection with the acquisition or distribution of a security that is the subject of a distribution; or (2) affiliates who control the purchase of such securities by a distribution participant, or whose purchases are controlled by a distribution participant, or whose purchases are under common control with those of a distribution participant.

The Commission believes that Regulation M should reflect the structural complexity of multi-service financial organizations, the administrative costs incurred by such entities in complying with Rule 10b–6, and the precedents recognizing information barriers as an element of exemptions from Rule 10b–6.[48] The Commission proposes that Rule 100 would exclude an affiliate of a distribution participant from the coverage of Rule 101 if the distribution participant establishes, maintains, enforces, and reviews at least annually written policies and procedures to separate its corporate finance activities conducted in connection with a distribution from the trading operations of the affiliate (''information barriers'')[49] and the affiliate is a separate and distinct organizational entity from, with no officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support

the Commission deems special selling efforts and selling methods to be used throughout the shelf offering for purposes of Rule 10b–6.

[45] *See* Concept Release, 59 FR at 21686.

[46] Rule 10b–6(c)(2) defines the term as:

A person (i) who has decided to submit a bid to become an underwriter of securities as to which the issuer or other person on whose behalf the distribution is to be made, has issued, directly or indirectly, an invitation for bids, or (ii) who has reached an understanding, with the issuer or other person on whose behalf a distribution is to be made, that he will become an underwriter, whether or not the terms and conditions of the underwriting have been agreed upon. 17 CFR 240.10b–6(c)(2).

[47] *See* Concept Release, 59 FR at 21686. *See also* Release 34–19565, 48 FR at 10634–10635.

[48] *See* Securities Exchange Act Release No. 36033 (July 31, 1995), 60 FR 40212; *Letter regarding CS Holding,* [1995] Fed. Sec. L. Rep. (CCH) ¶ 77,018 (March 31, 1995) (''CS Holding Letter'').

[49] The information barriers may be established pursuant to separate regulatory requirements. *See, e.g.,* 2 NYSE Guide (CCH) ¶ 2098 (requiring that information barriers be established that place substantial limits on access to, and communication of, trading information, including strategies and positions, between a specialist organization and an affiliated entity); *Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information,* Report by the Division of Market Regulation to the Securities and Exchange Commission (March 1990); *Broker-Dealer Internal Control Procedures for High Yield Securities,* Report by the Division of Market Regulation to the Securities and Exchange Commission (October 1993).

personnel) in common with, the distribution participant.[50]

A distribution participant would be required to obtain an independent review at least annually of its compliance during the preceding year with the policies and procedures governing its information barriers, including the operation and any breaches of such barriers, and to report on the findings of such review to its management.[51] The distribution participant's internal audit group could perform the review if the group were independent of the corporate financing and trading departments.[52]

Q21. Would this proposed definition appropriately narrow the types of affiliates that should be deemed ''affiliated purchasers''?

Q22. Is it appropriate to rely on information barriers to exclude certain affiliates of distribution participants from the restrictions of Rule 101?

Q23. Can information barriers be established effectively within the same organizational entity so as to preclude opportunities to manipulate the price of a security that is the subject of a distribution?

Q24. Should the independent annual review be conducted by an external reviewer (such as an accounting firm)?

Q25. The requirement under Rule 10b–6 of no common employees, other than clerical, ministerial, or support personnel, would be retained; however, the requirement of separate employee compensation arrangements would be discontinued. Should the separate employee compensation requirement be retained? Should shared employees or officers be permitted?

Q26. How would this definition affect the operations of distribution participants? Do they now conduct their corporate finance activities in separate and distinct organizational entities from their trading operations?

Q27. How would this definition affect investment advisers and other non-broker-dealer fiduciaries?

Q28. How would this definition affect non-U.S. distribution participants and their affiliates, including non-U.S. entities that are permitted to engage in both commercial and investment banking activities (*e.g.*, universal banks)?

6. Activities Excepted From Rule 101: Paragraph (b)

a. Generally

As with Rule 10b–6, the Commission believes that certain activities should be excepted from the prohibitions of proposed Rule 101 because of the need to facilitate orderly distributions of securities, or to limit potential disruptions in the trading market, or because the activity has little manipulative potential. The exceptions to Rule 10b–6 are prefaced with a proviso that such activities are not prohibited if not ''engaged in for the purpose of creating actual, or apparent, active trading in or raising the price of any such security.'' The Commission does not propose to include this proviso in Rule 101 because it adds an element of complexity that does not appear to be warranted in light of the new structure of Rule 101. Activities permitted by Rule 101 would remain subject to the general anti-fraud and anti-manipulation protections of the Securities Act and Exchange Act.

b. Exception 1—Research

Rule 10b–6 and Rule 101 prohibit any person participating in a distribution from inducing others to purchase securities covered by the rule. To reflect recent amendments to Securities Act Rule 139,[53] and to codify and expand the staff's interpretations regarding research, Rule 101 would permit written information, opinions, or recommendations that satisfy Rule 138 or 139 under the Securities Act to be published or disseminated in the ordinary course of its business by a distribution participant during the restricted period.[54] The proposed exception is intended to harmonize treatment of research under Securities Act and Exchange Act rules.

Although research distributed in the ordinary course of business that complies with Rule 138 or 139 would be excepted from Rule 101, research transmitted by sales personnel to customers who normally would not receive it in the ordinary course of business can constitute a solicitation to purchase.[55] This directed research, or execution of orders resulting from directed research, would not be permissible during the Rule 101 restricted period.

Q29. Should the circulation of offering materials and other publications outside of the United States be excepted from Rule 101, as some commenters have suggested?

c. Exception 2—Transactions Complying With Certain Other Rules

Rule 101 would provide an exception for transactions complying with Rules 103 or 104 of Regulation M (governing passive market making and stabilization). This proposed exception incorporates paragraphs (a)(4)(xiv) and (a)(4)(viii), respectively, of Rule 10b–6.

d. Exception 3—Odd-Lot Transactions

The Commission proposes to expand the exception for odd-lot transactions contained in Rule 10b–6(a)(4) to permit distribution participants to bid for and purchase odd-lots during the restricted period.

e. Exception 4—Exercises of Securities

The Commission proposes an exception to permit the exercise of call options and other securities to acquire a covered security. Many securities having associated standardized options would not be subject to Rule 101 because of the proposed exception for actively-traded securities, and other securities underlying standardized call options generally would be subject to the proposed one business day cooling-off period. These changes, coupled with the unpredictability of the timing or the extent of any purchases by parties who are exercised against, would reduce significantly the likelihood that the exercise of call options would be used to facilitate a distribution. Therefore, the Commission proposes to eliminate the five business day cooling-off period contained in Rule 10b–6 for the exercise of standardized call options. Under proposed exception 4, distribution participants would be permitted to exercise call options during the restricted period, regardless of when the options were acquired.

The Commission also proposes to except exercises of options or warrants, rights received in connection with a rights offering, or rights or conversion privileges set forth in the instrument

[50] Distribution participants and their affiliates would not be required to have separate compensation arrangements to qualify for this exclusion. *Cf.* Rule 10b–6(c)(6)(i)(D)(2).

[51] Consistent with Rule 17a–4(b)(4) under the Exchange Act, registered brokers and dealers would be required to maintain and preserve the review for a period of not less than three years, the first two years in an accessible place. 17 CFR 240.17a–4(b)(4).

[52] *See* CS Holding Letter, *supra* note 48.

[53] Securities Act Release No. 7132 (February 1, 1995), 60 FR 6965.

[54] 17 CFR 230.138 and 230.139. The Commission's staff has taken the position that certain research reports are not prohibited inducements if they are issued by a broker-dealer in the ordinary course of business and satisfy Rule 138 or Rule 139(b) under the Securities Act, or satisfy Rule 139(a) and do not contain a recommendation or earnings forecast more favorable than that previously disseminated by the firm. *See* Securities Exchange Act Release No. 21332 (September 19, 1984), 49 FR 37569, 37572 n.25. The current interpretive limitations on more favorable earnings forecasts or recommendations in research reports would not be included in exception 1.

[55] Distribution participants also must consider the broker-dealer registration requirements of Section 15(a) of the Exchange Act and the rules thereunder in connection with continuous distributions of research reports to investors. 15 U.S.C. 78o(a).

governing a security to acquire any security directly from an issuer. This would include exercises by distribution participants of rights acquired during a distribution through rights. Consistent with exception (vii) of Rule 10b–6, this provision of Rule 101 is intended to permit exercises or conversions of securities that do not entail any significant market impact or manipulative potential, and thus do not involve the concerns at which the anti-manipulation regulation of securities distributions is directed.

Q30. Would any activity permitted by this exception raise manipulative concerns because of a significant market impact?

f. Exception 5—Unsolicited Brokerage Transactions

The Commission proposes to include in Rule 101 the exception for brokerage transactions not involving solicitation of the customer's order that is contained in Rule 10b–6(a)(4)(v)(A).

g. Exception 6—Basket Transactions

Commenters recommended that the Commission adopt some form of relief for transactions effected as part of a basket strategy if the basket is not used for manipulation. Basket trading involves contemporaneous transactions in groups of securities that often are related to a standardized index. The Commission has granted Rule 10b–6 relief for standardized basket transactions subject to certain conditions, including those relating to the number of securities to be purchased, the weighting of the distribution security in the basket, and the timing of the basket transaction.[56] Several commenters supported expanding and streamlining the treatment of basket transactions in view of the increasing importance of such transactions to institutional investors, and the need of broker-dealers to provide liquidity to these investors.

The Commission is proposing to include an exception for purchases of covered securities made in connection with a basket transaction. This exception would be available with respect to both index-related baskets and baskets unrelated to any standardized index.[57] Proposed paragraph (b)(6) of Rule 101 would apply to transactions in covered securities when: (1) the aggregate dollar value of any bids or purchases of the security in distribution constitutes 5% or less of the total dollar value of the basket being purchased; and (2) the basket contains at least 20 stocks. The basket transaction also would have to 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). The 5% and 20 stock criteria are intended to provide an objective indication of the *bona fide* nature of a basket transaction and to limit the exception to those basket transactions where the security in distribution represents a small portion of the basket, such that use of the basket transaction to facilitate a distribution would not be economical. These criteria also would provide flexibility for basket transactions.

The exception also would permit 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.

Q31. In view of the exception for actively-traded securities, is this exception necessary?

Q32. Should the exception be unavailable in the last hour of trading before the pricing of an offering because basket transactions can involve significant amounts of stock and may have an impact on the security's price? If a last-hour restriction were imposed in this exception, would a further relaxation of the 5% and 20 stock parameters be justified?

h. Exception 7—*De Minimis* Transactions

Several commenters cited the consequences of ''insignificant'' violations of Rule 10b–6 by a distribution participant, particularly bids for, or small trades in, covered securities effected during the cooling-off period. These violations have resulted in the distribution participant dropping out of an underwriting syndicate, or the postponement of the offering.

In the past, at a distribution participant's request, the Commission's staff has taken informal no-action positions with regard to the occurrence of such violations in cases where the transactions were represented to be inadvertent and appeared to have had no market impact. Frequently, these transgressions occurred because of a failure to follow policies and procedures established by the firm to comply with Rule 10b–6. Based on the inadvertent nature of many of these violations and the lack of market impact, coupled with the impact of such violations on distribution participants and offerings, some commenters recommended that the Commission consider a safe harbor approach for such activity that was not undertaken with a manipulative purpose.

To address these concerns, the Commission is proposing an exception to Rule 101 for certain *de minimis* transactions. A *de minimis* transaction would be defined as a bid that was not accepted, or one or more purchases that in the aggregate total less than 1% of the security's ADTV. Because this proposed exception is intended to cover ''inadvertent'' violations, and not bids or purchases wilfully made in violation of the rule, it would be available only when the firm had established and enforced policies and procedures reasonably designed to achieve compliance with Rule 101. Inadvertence also would be evidenced by prompt cessation of the activity upon its discovery.[58]

Q33. Would this exception address the problems experienced with respect to ''inadvertent'' violations under Rule 10b–6?

Q34. Is 1% of the security's ADTV the appropriate level to be considered *de minimis*?

Q35. Would an alternative exception containing the 1% ADTV threshold, but permitting bids and purchases whether or not in violation of procedures, be preferable? In view of the increased latitude that would be provided by this alternative, the Commission believes that it may be necessary to make the exception unavailable for transactions effected during the last hour of trading prior to pricing the offering.

i. Exception 8—Transactions in Connection with the Distribution

A variety of transfers, allocations, and reallocations of securities are necessary in the course of conducting a distribution. These transactions should not be effected in a manner that may affect the price of, or give an appearance of trading activity in, covered securities. The Commission proposes exception 8 to permit *non-publicly reported* transactions among distribution participants to allocate and reallocate

[56] *See Letter regarding Basket Trading During Distributions*, [1991] Fed. Sec. L. Rep. (CCH) ¶ 79,752 (August 6, 1991).

[57] As a practical matter, a high percentage of the securities involved in basket transactions would be covered by the proposed exception for actively-traded securities.

[58] A firm's reliance on this exception on repeated occasions would raise questions about the adequacy and effectiveness of the firm's procedures. Therefore, upon the occurrence of any violation, a broker-dealer would be expected to review its policies and procedures and modify them as appropriate to prevent future violations.

securities among syndicate members in connection with a distribution, and *non-publicly reported* purchases of securities from the issuer or selling securityholders necessary to conduct the distribution. Exception 8 is consistent with the objective of exception (i) of Rule 10b–6, which permits transactions in connection with a distribution that are effected otherwise than on a securities exchange with the issuer or other person or persons on whose behalf such distribution is being made, or among underwriters, prospective underwriters, brokers, dealers, or other persons who have agreed to participate or are participating in such distribution. It reflects, however, the fact that many over-the-counter (''OTC'') transactions today are as transparent as exchange transactions. Therefore, the proposed exception would apply only to transactions among distribution participants, issuers, or selling securityholders that are effected otherwise than on or through the facilities of a securities exchange *or* an inter-dealer quotation system (*e.g.*, Nasdaq). Exception 8 also would permit offers and sales of, and the solicitation of offers to buy, the securities being distributed, including securities acquired in stabilizing transactions, which are permitted under exception (vi) of Rule 10b–6.

j. Exception 9—Distributions of Rule 144A Securities

Several commenters recommended expanding Rule 10b–6(i) which excepts distributions of Rule 144A-eligible foreign securities if the securities are sold solely to qualified institutional buyers (''QIBs'') in transactions exempt from registration under the Securities Act (''Rule 144A distributions'').[59] After considering the comments received, the Commission proposes to expand this exception in proposed Rule 101 to include Rule 144A distributions of domestic issuers' securities. In light of the characteristics of transactions involving Rule 144A securities (*e.g.*, eligible securities are not listed on a U.S. exchange or quoted on Nasdaq, and Rule 144A transactions are limited to QIBs), the Commission has determined not to distinguish between Rule 144A distributions of foreign and domestic securities. The exception also would apply to a distribution of Rule 144A-eligible securities to non-U.S. persons, within the meaning of paragraphs (o)(2) and (o)(7) of Regulation S under the Securities Act, that is made concurrently with a Rule 144A distribution to QIBs.[60]

The Commission notes that an exception from proposed Rule 101 based on the category of persons to whom the securities are distributed may be viewed as a departure from the anti-manipulation purposes of Regulation M, because no class of investors, including large institutions, is immune to injury from securities fraud or manipulation.[61] However, based on the ability of QIBs to obtain, consider, and analyze market information, the Commission believes that it may be appropriate to reduce the scope of Rule 101's *prophylactic* protections for such market participants. Although some commenters recommended expanding the exception to include offerings of Rule 144A-eligible securities to institutional accredited investors in addition to QIBs, the Commission is not adopting that recommendation because it encompasses a much broader category of investors, all of whom may not have comparable characteristics.

Q36. Is it appropriate to except certain distributions of securities from Rule 101 based in part on the class of persons to whom the securities are offered (*e.g.*, QIBs)?

Q37. In light of the new exception for actively-traded securities, which will except many distributions of Rule 144A-eligible foreign securities from the rule, does an exception expressly covering Rule 144A distributions continue to be necessary or appropriate?

Q38. Do QIBs favor this exception and agree with its rationale?

7. Rule 10b–6 Exceptions That Are Not Included in Proposed Rule 101

a. Unsolicited Privately Negotiated Purchases

Rule 10b–6(a)(4)(ii) permits unsolicited privately negotiated purchases, each involving at least a block of securities, that are not effected from or through a broker or dealer. This exception was adopted in response to industry concerns regarding the need to permit issuers and distribution participants to purchase blocks of securities ''overhanging'' the market during a distribution.[62]

The staff's experience is that this provision is very seldom utilized, and does not appear to be necessary to facilitate orderly distributions. Therefore, and in light of the shortened restricted periods and the proposed exception for unsolicited brokerage transactions, the Commission is not proposing an exception from the rule for privately negotiated, unsolicited purchases of securities.

Q39. Does an exception for unsolicited privately negotiated purchases continue to be necessary? If so, should there be any requirements as to the size of the purchases (*e.g.*, a block) or whether the purchases were unsolicited? Should such an exception be available for purchases by a broker-dealer?

b. Sinking Fund Obligations

Rule 10b–6(a)(4)(iii) provides an exception to permit an issuer to satisfy its mandatory sinking fund obligations that become due within 12 months from the date of purchase (*i.e.*, those that are current).[63] The Commission is of the view that this exception no longer appears to be necessary and thus does not propose to include within Rule 101 an exception for purchases to satisfy sinking fund or similar obligations.

Q40. Is there any reason to retain this exception?

c. Rights Offerings

The Commission is of the view that Rule 10b–8 contains overly rigid and complex restrictions on purchases of rights and, unlike the other trading practices rules, regulates sales of the offered security. These restrictions may no longer be necessary. Rights offerings today generally are conducted in a manner designed not to trigger Rule 10b–8's restrictions on purchases of rights. The Commission proposes to rescind Rule 10b–8 to conform with Regulation M's treatment of derivative securities. Therefore, bids and purchases of rights would not be covered by Rule 101. Bids and

[59] *See* 17 CFR 230.144A.

[60] 17 CFR 230.902(o)(2) and 230.902(o)(7). This would codify the position taken 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).

[61] *Cf. BT Securities Corporation*, Securities Exchange Act Release No. 35136 (December 22, 1994); *In re Scientific Control Corp. Sec. Litig.*, 71 F.R.D. 491, 512 (S.D.N.Y. 1976) (both sophisticated and unsophisticated investors are entitled to protection from the disclosure and anti-fraud provisions of the securities laws).

[62] In 1983, the Commission deleted the requirement that transactions effected in reliance on the exception not be made on an exchange in recognition of the fact that both third market and exchange transactions in reported securities are reported to the consolidated transaction reporting system (''consolidated system''). Release 34–19565, 48 FR at 10634. *See also* Release 34–18528, 47 FR at 11489.

[63] A sinking fund is a capital reserve set aside annually from current earnings to provide funds to retire a particular bond issue or debt security, in whole or in part, prior to the security's maturity date. *See* Release 34–18528, 47 FR at 11490 n.44.

purchases of the security that is the subject of the rights offering, however, would be restricted by Rule 101.

Q41. Should the Commission continue to regulate rights offerings through a separate rule?

Q42. Recently, a number of closed-end funds have conducted rights offerings. Do rights offerings by closed-end funds present any special manipulative concerns that should be addressed by Regulation M?

8. Exemptive Authority

The Commission proposes to include within Rule 101 the authority to grant exemptions from Rule 101. This provision is similar to paragraph (j) of Rule 10b–6.

*C. Rule 102—Activities by Issuers and Selling Securityholders*

1. Generally

The Commission is proposing new Rule 102, which would govern the activities of issuers, selling securityholders (*i.e.*, any person other than an issuer on whose behalf a distribution is being made), and their affiliated purchasers in connection with a distribution of securities. Rule 102 would make it unlawful for such persons to bid for, purchase, or to attempt to induce any person to bid for or purchase any security that is the subject of such distribution and any reference security for such security during the applicable restricted period.

Q43. Commenters should discuss whether an exception from the definition of ''affiliated purchaser'' should be available to affiliates of an issuer or selling securityholder who establishes, maintains, and enforces written policies and procedures regarding information barriers in compliance with Rule 100. Under what circumstances would issuers or selling securityholders establish information barriers?

Q44. Should the rule provide more guidance as to how the ''affiliated purchaser'' concept would apply where a distribution participant (subject to Rule 101) is an affiliate of an issuer or selling securityholder?

2. Excepted Securities

An issuer or selling shareholder may have a substantial incentive to raise improperly the price of offered securities. Also, issuer and shareholder transactions are not as readily identifiable from a surveillance perspective as those of distribution participants. Thus, the Commission preliminarily believes that it may not be appropriate to extend the exception for actively-traded securities, or the exception for investment grade debt and investment grade preferred securities provided in Rule 101, to issuers, selling securityholders, or their affiliated purchasers.

The Commission does propose, however, to provide an exception from Rule 102 for ''exempted securities,'' as defined in Section 3(a)(12) of the Exchange Act, and face-amount securities or securities issued by an open-end management investment company or unit investment trust.

Q45. Should issuers be provided with an exception for actively-traded securities? If so, are any new procedures necessary to assist the exchanges or the NASD with surveillance of issuer transactions in such securities?

Q46. Do issuers, selling securityholders, or their affiliated purchasers rely on the exception for investment grade debt securities in Rule 10b–6? If so, under what circumstances?

3. Excepted Activities

a. Generally

The Commission is proposing fewer exceptions from the restrictions of Rule 102 than it is proposing in connection with Rule 101. Rule 102 differs from Rule 101 because of the view that issuers and selling securityholders have a direct and immediate stake in the proceeds of offerings, and do not engage in the same types of market activities as broker-dealers. Moreover, SRO surveillance mechanisms can detect more quickly, *i.e.*, on a real-time basis, the market activities of their member firms that are distribution participants, while transactions by issuers and their affiliated purchasers are not as readily identifiable.

b. Exception 1—Odd-Lot Transactions

As with Rule 101, the Commission proposes to except from Rule 102 bids for or purchases of securities in odd lots. Among other things, paragraph (b)(1) would permit issuers to conduct odd-lot tender offers during the restricted period.

c. Exception 2—Transactions Complying With Rule 23c–3 of the Investment Company Act of 1940

Paragraph (b)(2) of Rule 102 would provide an exception for repurchases of equity securities pursuant to Rule 23c–3 under the Investment Company Act of 1940.[64]

[64] Rule 23c–3 under the Investment Company Act of 1940, 17 CFR 270.23c–3, permits periodic repurchases of common stock by issuers that are registered closed-end investment companies as well as business development companies.

d. Exception 3—Exercises of Securities

The Commission proposes to except from Rule 102 exercises of call options and other securities and exercises of any right or conversion privilege set forth in the instrument governing a security, which provides for purchasing a security directly from the issuer, including rights issued in a rights offering. This provision is intended to permit affiliated purchasers of issuers to exercise rights in connection with convertible, exchangeable, or exercisable securities, including options received in connection with employee benefit plans.

e. Exception 4—Transactions in Connection With the Distribution

Rule 102 would provide an exception for offers to sell or the solicitation of offers to buy the securities being distributed. This exception, which comports with Rule 10b–6(a)(4)(vi), would permit an issuer or selling securityholder to conduct the offering on its own behalf.

Q47. What is the impact on issuers of not providing for other transactional exceptions, such as the exception for unsolicited privately negotiated purchases or stabilizing transactions? Do issuers or selling securityholders rely on other exceptions in Rule 10b–6? If so, how often and for what purpose? Persons urging additional exceptions for issuers should provide reasons why they are warranted.

4. Plans

The Concept Release solicited comment on whether issuer plans should be distinguished from other types of distributions of securities, and whether plans should be distinguished based on the nature of the participants, *e.g.*, when the plan is available only to certain groups having a relationship to the issuer. Rule 10b–6(e) excludes from the rule's coverage any distribution of securities by an issuer or a subsidiary of the issuer to *employees or securityholders* of the issuer or its subsidiaries, or to a trustee or other person acquiring such securities for the account of such employees or securityholders pursuant to a ''plan,'' as defined in Rule 10b–6(c)(4).[65]

Many issuers, however, no longer limit participation in their plans to securityholders or employees. Issuers have extended plan participation to, among others, retirees, outside directors,

[65] ''Plan'' is defined as ''any bonus, profit-sharing, pension, retirement, thrift, savings, incentive, stock purchase, stock ownership, stock appreciation, stock option, dividend reinvestment or similar plan for *employees or shareholders* of an issuer or its subsidiaries.'' (emphasis supplied).

agents, consultants, suppliers, franchisees, independent contractors, and family members of such persons, as well as credit card holders and other customers. Moreover, some plans permit prospective investors to participate by making an initial cash payment, rather than requiring prior share ownership. Issuer plans that allow participation by persons other than their employees or securityholders, or those of their subsidiaries, do not qualify for the exception.

The Division of Market Regulation, acting pursuant to delegated authority, in 1994 granted a class exemption from Rule 10b–6 that facilitates investors' access to plans by permitting investors to obtain their first share of an issuer's securities directly from the issuer, and expands the availability of these programs to persons other than the issuer's employees and securityholders.[66] Many issuers have relied on this exemption in implementing dividend reinvestment and stock purchase plans. The staff also recently has provided no-action relief from Rule 10b–6 for securities purchase and sale service programs offered by bank-registered transfer agents.[67] These actions appear to have addressed most of the concerns of the ten commenters who discussed plans. Therefore, the Commission proposes to simplify the treatment of plans under Rule 102 by codifying this relief and further reducing the restrictions on plan transactions.

For purposes of Rule 102, plans would be divided into three different groups: (1) plans that are available only to employees and shareholders; (2) plans that are available to persons other than employees and shareholders where securities for the plan are purchased from a source other than the issuer or an affiliated purchaser, *i.e.*, in the open market or in privately negotiated transactions, by an agent independent of the issuer; and (3) plans that are available to persons other than employees and shareholders where securities for the plan are purchased directly from the issuer or an affiliated purchaser (''direct issuance plans'').[68]

The Commission proposes to exclude from Rule 102 any distribution pursuant to a plan by or on behalf of an issuer or a subsidiary of an issuer, when such distribution is made solely to employees or shareholders of the issuer or its subsidiaries, or to a trustee or other person acquiring such securities for the accounts of such person. This provision remains essentially unchanged from Rule 10b–6(e). For purposes of this exception, however, the term ''employee'' would have the same meaning as contained in Form S–8 of the Securities Act relating to employee benefit plans.[69] Thus, distributions by plans that allow directors, general partners, insurance agents, former employees, consultants, and certain advisors to participate in their plans are proposed to be excepted from Rule 102. This reflects the view that persons that are not employees of an issuer or a subsidiary of an issuer may have a relationship with an issuer that is sufficiently similar to that of an employee such that it is appropriate to treat such persons in the same manner as employees for purposes of this exception. Further, this will provide consistency between the Securities Act and the Exchange Act regarding the types of issuer sponsored programs that are considered to be plans.

Second, the Commission proposes to except all distributions involving plans that include persons other than employees or shareholders where purchases for the plan are made from sources other than the issuer or an affiliated purchaser (*i.e.*, in the open market or in privately negotiated transactions) by an agent independent of the issuer. The Commission believes that when an agent independent of the issuer effects plan transactions, the issuer's opportunity to engage in improper conduct is reduced greatly. The Commission proposes to include the definition of ''agent independent of the issuer'' in Rule 100, rather than referring to the definition of that term presently in Rule 10b–18(a)(6) under the Exchange Act.[70] Except with respect to the issuer's ability to change its determination once every three months regarding the source of shares to fund a plan, an agent would not be considered independent if the issuer directs the agent as to the source of shares, or the timing of purchases of shares (*e.g.*, a requirement that shares to fund the plan must be purchased on the plan's investment date). The issuer, however, may establish general conditions for the operation of the plan, including, for example, requirements with respect to the return of uninvested funds to plan participants, and requirements that optional cash payments be invested within 35 days of receipt.[71]

Third, the Commission proposes that a direct issuance plan (*i.e.*, a plan that is open to persons other than employees or securityholders, and where shares are purchased from the issuer or an affiliated purchaser) would be subject to Rule 102 when offers and sales of securities pursuant to the plan constitute a ''distribution'' within the meaning of Rule 100. Thus, the ''magnitude'' and ''special selling efforts and selling methods'' tests would be applied to offers and sales under such plan to determine whether a distribution exists. In determining the magnitude of an offering of plan shares, an issuer would need to consider the amount of securities it distributes through the plan directly and indirectly (e.g., by broker-dealers who obtain securities from the issuer as participants in a plan by virtue of being securityholders and then distribute the shares to the public). In determining whether special selling efforts or selling methods are involved, for purposes of a plan, selling efforts consistent with the solicitation activities permitted in the 1994 STA Letter would be presumed not to involve special selling efforts and selling methods for purposes of determining the existence of a distribution. The treatment of direct issuance plans under Regulation M recognizes that these plans potentially can be capital raising transactions analogous to the types distributions that historically have been subject to Rule 10b–6.

These proposed changes are intended to reduce significantly and, in most cases, eliminate the rule's application to

[66] *See* 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). The 1994 STA Letter also provided the staff's views on Sections 15(a) and 17A of the Exchange Act, 15 U.S.C. 78o(a) and 78q–1, respectively.

[67] *See Letter Regarding First Chicago Trust Company of New York,* [1994] Fed. Sec. L. Rep. (CCH) ¶ 76,939 (December 1, 1994); *Letter Regarding Bank-Sponsored Investor Services Programs,* [1995] Fed. Sec. L. Rep. (CCH) ¶ 77,122 (September 14, 1995) (''Bank-Sponsored Programs Letter''). These letters also took no-action positions with regard to Section 5 of the Securities Act, and Sections 13(e), 14(d), and 14(e) of, and Rule 10b–13 under, the Exchange Act, 15 U.S.C. 77e, 78m(e), 78n(d), and 78n(e), and, in the case of the Bank-Sponsored Programs Letter, Section 15(a) of the Exchange Act.

[68] As provided by paragraph (g) of Rule 10b–6, the Commission proposes to exclude from Rule 102 any bids or purchases of a security made or effected by or for a plan by an ''agent independent of the issuer.'' *See infra* note 70 (discussing the definition of ''agent independent of the issuer'').

[69] 17 CFR 239.16b. The definition of plan would be expanded to include plans within the meaning of paragraph (c)(4) of Rule 10b–6 as well as dividend or interest reinvestment plans or employee benefit plans, as defined in Rule 405 of Regulation C. 17 CFR 230.405.

[70] 17 CFR 240.10b–18(a)(6). The definition of ''agent independent of the issuer'' would be substantially the same as under paragraph (a)(6) of Rule 10b–18. It also is proposed that Rule 10b–18 be amended to refer to the definition in proposed Rule 100.

[71] *See* 1994 STA Letter, *supra* note 66 (modifying *Letter regarding Lucky Stores Inc.,* [1974–1975] Fed. Sec. L. Rep. (CCH) ¶ 79,903 (June 5, 1974)).

issuer plans. Of course, issuers that employ their plans for manipulative purposes would continue to be subject to the anti-fraud and anti-manipulation provisions of the federal securities laws.[72]

Q48. Do these proposals strike the appropriate balance? Are any manipulative incentives raised by plan distributions?

Q49. Is it appropriate to distinguish plans available only to employees and securityholders from other plans for purposes of this rule? Is it appropriate to distinguish direct issuance plans from other plans for purposes of this rule?

5. Exemptive Authority

The Commission proposes to include within Rule 101 the authority to grant exemptions from Rule 101. This provision is similar to paragraph (j) of Rule 10b–6.

6. Rule 10b–18

Rule 10b–18 provides that the issuer and its affiliated purchasers will not incur liability under the anti-manipulation provisions of Sections 9(a)(2) or 10(b) of the Exchange Act or Rule 10b–5 thereunder, if purchases of the issuer's common stock are effected in compliance with the conditions contained in that rule relating to the time, price, volume, and manner of purchases of the issuer's common stock.[73] The Commission does not believe that a safe harbor should be available in circumstances that raise reasonably identifiable manipulative incentives. Accordingly, in light of the special incentives that an issuer and its affiliated purchasers may have in facilitating sales of the issuer's securities that are the subject of a distribution, the Commission is proposing to revise the definition of a ''Rule 10b–18 purchase'' to clarify that the safe harbor is not available during a distribution of the issuer's common stock that is subject to Rule 102, or during a distribution for which such stock is a reference security.[74] Under the proposals, the Rule 10b–18 safe harbor would be unavailable during the entire course of the distribution, and not only during the applicable restricted period. The proposed amendment would codify an informal staff interpretation and more clearly define the parameters of the Rule 10b–18 safe harbor.

As noted earlier in the discussion of the treatment of shelf offerings as distributions for purposes of Regulation M, the Commission is of the view that generally each takedown off a shelf should be examined individually to determine whether it constitutes a distribution for purposes of Rule 100. Accordingly, if the issuer determines to go forward with a distribution of common stock pursuant to a shelf registration statement, the Rule 10b–18 safe harbor would be unavailable from the time of that determination until sales pursuant to the takedown are completed.

Q50. Will the proposed revision to the definition of ''Rule 10b–18 purchase'' have any significant impact on issuers' repurchase programs? Commenters that believe that there will be an impact should describe how such programs will be affected.

*D. Rule 103—Passive Market Making*

1. Discussion of Rule 103

Proposed Rule 103 would replace Rule 10b–6A, which was adopted in 1993.[75] Rule 103 would permit ''passive market making'' in connection with the distribution of securities quoted on Nasdaq during the restricted periods of Regulation M, when proposed Rule 101 otherwise would prohibit such transactions. The purpose of the proposed rule (and Rule 10b–6A) is to alleviate special liquidity problems that may exist in the Nasdaq market during the restricted period, when distribution participants or their affiliates that are Nasdaq market makers otherwise must withdraw from the market. In general, exchange-traded securities are not similarly affected because independent specialists are assigned to provide depth and liquidity in listed securities.

Rule 103 would incorporate many provisions of Rule 10b–6A. Rule 103 generally would limit a passive market maker's bids and purchases to the highest current independent bid, *i.e.*, a bid of a Nasdaq market maker that is not participating in the distribution. Additionally, the rule would limit the amount of purchases that each passive market maker could make and the displayed size of the bid, and contain requirements relating to identification, notification, and disclosure of passive market making.

Several commenters and others experienced with Rule 10b–6A have suggested allowing Nasdaq market making in a greater number of contexts than is permitted under the current criteria. Rule 10b–6A defines an ''eligible security'' as a Nasdaq security that: (1) is the subject of a firm commitment, fixed price offering registered under the Securities Act or is a related security; (2) has a minimum price of $5.00 per share and a minimum public float of 400,000 shares; and (3) has Nasdaq market makers that are underwriters or prospective underwriters, or affiliated purchasers of underwriters or prospective underwriters, that account for at least 30% of the total trading volume in such security.[76] These eligibility criteria were designed to limit the availability of passive market making to those firm commitment offerings of securities qualifying for the two business day cooling-off period of Rule 10b–6, when the restrictions of that rule otherwise would have reduced market making capacity significantly.

The Commission believes that eliminating the rule's eligibility criteria, thereby permitting passive market making in a greater number of contexts, is consistent with the purposes of Regulation M. Rule 103 would eliminate almost all of the eligibility criteria contained in Rule 10b–6A(b)(3). The Commission no longer considers it necessary to restrict passive market making to the class of offerings where the potential liquidity loss may be substantial. Under the proposals, however, best efforts and at the market offerings would remain ineligible for passive market making.[77]

Rule 103 also would extend the period when passive market making is permitted, and increase the number of eligible securities. Rule 10b–6A restricts passive market making to the two business day cooling-off period, and prohibits passive market making upon the commencement of offers and sales or when stabilization commences. The new rule would permit passive market making throughout the applicable restricted period, but would continue to prohibit passive market making when stabilization is being conducted. Under the proposals, all Nasdaq securities would qualify for passive market

[72] In addition, to avoid broker-dealer registration under Section 15(a) of the Exchange Act, an issuer operating a plan must limit its activities in accordance with the conditions set forth in the 1994 STA Letter. For example, the issuer may perform only purely clerical and ministerial functions, including forwarding cash and securities to an independent broker-dealer or bank, in connection with the plan.

[73] 17 CFR 240.10b–18.

[74] *See* 17 CFR 240.10b–18(a)(3). The Commission notes that although the Rule 10b–18 safe harbor would not be available, this does not mean that such purchases necessarily would violate Sections 9(a)(2) or 10(b), or Rule 10b–5.

[75] Securities Exchange Act Release No. 32117 (April 8, 1993), 58 FR 19598 (''Release 34–32117'').

[76] See 17 CFR 240.10b–6A(b)(3).

[77] The Commission previously has noted that the NASD surveillance system does not easily accommodate at the market offerings. Release 34–32117, 58 FR at 19600. The Commission notes that the NASD's surveillance of passive market making is an essential consideration in the proposal to expand the contexts in which passive market making would be permitted.

making. The rule also would permit passive market making in Nasdaq reference securities (*e.g.*, the underlying common stock during a distribution of a convertible security).

In addition, passive market makers could bid for one round lot of securities if their initial or remaining net purchasing capacity is between one and 99 shares. This provision would permit more syndicate members to be passive market makers and also would respond to commenters who suggested greater flexibility for passive market making.

To provide flexibility in the operation of passive market making, a market maker is not required to lower its quotation to reflect lower independent bids until it purchases an amount equal to five times the maximum order size for the particular security, as provided for under the NASD's rules for the Small Order Execution System (''SOES''). In order to account for possible changes to Nasdaq operations, the Commission proposes to allow a passive market maker to purchase an amount that equals or exceeds two times the minimum quotation size for the security as determined by the NASD, before it is required to lower its quotations to reflect lowered independent bids.[78] Moreover, passive market makers facilitating the execution of customer orders would be able to make bids or purchases at a price above the independent price where necessary to comply with any Commission or NASD rule relating to the execution of customer orders.[79]

Q51. Are the proposals to delete the requirements of the definition of ''eligible security'' in Rule 10b–6A appropriate? Is it appropriate to extend passive market making to Nasdaq securities with an ADTV value under $100,000?

Q52. Would the provision permitting passive market making for at least one round lot of a security assist Nasdaq market makers whose trading volumes are insufficient to qualify for passive market making? Is some other minimum purchase limitation appropriate, *e.g.*, two round lots or five round lots?

2. Postponement of Further Changes

The Commission is not proposing to make other revisions to passive market making regulation at this time because proposed Rule 101 would eliminate the need for passive market making for many actively-traded Nasdaq securities and would allow passive market making in many more contexts than permitted currently. Moreover, the Commission is aware that there have been a significant number of failures to comply with basic requirements of passive market making (*i.e.*, bid and purchase prices have exceeded the highest independent bid, and purchases have exceeded the rule's net purchase limitation). These incidents, along with the expansion of passive market making to cover more offerings and securities, suggest that it would be appropriate for the Commission to continue to monitor passive market making before proposing further changes. The Commission, however, intends to review passive market making under Rule 103, if adopted, and will consider other appropriate modifications.

Q53. In view of the compliance difficulties associated with Rule 10b–6A, are there any structural changes that could help to eliminate these problems, other than revisions to the rule's price and volume limitations?

Q54. Net purchases by a passive market maker are limited to 30% of its Nasdaq ADTV. Is this 30% Nasdaq ADTV limitation adequate to allow passive market making, particularly in light of the elimination of the provisions for SOES transactions, or should this threshold be revised, *e.g.*, by permitting net purchases of 50% of a market maker's Nasdaq ADTV?

*E. Rule 104—Stabilization and Other Syndicate Activities*

1. Background

The Commission is proposing new Rule 104 to govern stabilization. It would create a more flexible framework for managing the distribution process and eliminate much of the complexity in the operation of Rule 10b–7.[80] The Commission believes that stabilization should continue to be regulated because it is market activity during an offering that is intended to influence a security's price.[81]

Rule 104 would reflect the significant changes that have occurred in underwriting methods since Rule 10b–7 was adopted. For example, underwriters have developed highly effective means of quickly placing and controlling an offering through the book-building and allocation processes. Stabilization pursuant to Rule 10b–7 has become less common, perhaps in part because of the rule's limitations on increasing stabilizing bids, but also because of the development of efficient distribution methods and underwriters' concern that stabilization may indicate that an offering is progressing poorly. Nevertheless, underwriters continue to disclose in prospectuses that they reserve the right to stabilize an offering, and stabilization remains an important option in domestic and foreign contexts.

In their responses to the Concept Release, commenters recognized the importance of regulating stabilization, but were critical of Rule 10b–7's price restrictions, which prevent underwriters from adjusting stabilizing bids to reflect fluctuating markets and currency changes, and of the rule's reliance on U.S. markets to govern permissible stabilizing prices. Rule 104 reflects a fundamental shift from Rule 10b–7's structure, while codifying exemptive and no-action relief issued by the Commission and its staff within the last decade, particularly with respect to cross-border transactions.

2. Stabilizing Levels

The most significant proposed changes from Rule 10b–7 pertain to permissible stabilizing price levels. The Commission believes that these changes would afford greater flexibility to underwriters, which is especially important in the context of multinational securities offerings. Under Rule 10b–7, an underwriter generally must set its stabilizing bid based on the independent market price for the security, and cannot change that bid except in limited circumstances. In principal markets that are exchanges, initiation of stabilizing bids is limited by last sale prices. In other markets, independent bids are the reference price.

Rule 104 would allow persons effecting stabilizing transactions to establish a stabilizing bid with reference to prices in the principal market for the security, wherever located,[82] and then to maintain, reduce, or raise that bid to follow the independent market, as long as the bid does not exceed the highest

[78] *See, e.g.*, Securities Exchange Act Release No. 36548 (December 1, 1995), 60 FR 63092.

[79] *See Letter regarding Obligations of Passive Market Makers that Hold Customer Limit Orders*, [1995] Fed. Sec. L. Rep. (CCH) ¶ 77,040 (July 19, 1995).

[80] In addition to comments responding to the Concept Release, the proposed new rule is based on comments received in response to the 1991 Proposals. *See supra* note 15. The 1991 Proposals chiefly were intended to accommodate the increasing internationalization of securities markets and would be superseded by Regulation M. Therefore, they would be withdrawn if Regulation M is adopted.

[81] See Section 9(a)(6) of the Exchange Act, 15 U.S.C. 78i(a)(6); Concept Release, 59 FR at 21689. *See also* the Commission's 1940 policy statement on stabilizing, Securities Exchange Act Release No. 2446 (March 18, 1940).

[82] A U.S. market that is not the principal market would no longer control stabilizing price levels. The reference prices in the principal market must be reported pursuant to Rule 11Aa3–1 under the Exchange Act, 17 CFR 240.11Aa3–1, or be reported to a foreign financial regulatory authority as defined in Section 3(a)(52) of the Exchange Act, 15 U.S.C. 78c(a)(52).

independent bid and in no case exceeds the offering price of the security.[83] These provisions would provide significant flexibility to stabilization regulation, because they effectively would permit the stabilizing bid to follow the independent market for the security, limited by the offering price.

When the principal market is open, stabilizing price levels would be determined by the stabilizing bid in that market, and if there is no stabilizing bid, by the highest independent bid price in that market. If the principal market is closed and stabilizing has not been initiated in any market, no stabilizing could be effected at a price in excess of the lower of: (1) The price at which stabilizing could have been effected in the principal market at the close thereof; or (2) the most current reported price at which transactions in the offered security have been effected on any exchange or inter-dealer quotation system after the close of the principal market. After the opening of quotations or trading in the market where stabilizing will be effected, stabilizing could not be effected at a price higher than the highest independent bid price for such security reported in that market at the time such stabilizing is effected. Where an independent market for the offered security does not exists, stabilizing would be limited only by the offering price. Rule 104 also provides for adjustments to the stabilizing bid when the security being stabilized goes ex-dividend, ex-rights, or ex-distribution, 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.[84]

Q55. Do the provisions regarding stabilizing price levels create an effective framework to govern stabilizing transactions? Do the provisions regarding stabilizing price levels present any manipulative concerns?

3. Other Provisions Relating to Stabilization

As under Rule 10b–7, Rule 104 would provide that no person may effect either alone or with others any stabilizing transaction to facilitate an offering of any security in contravention of its provisions.[85] The term ''stabilizing'' would be 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 would retain provisions governing priority of independent bids, control and purpose of stabilizing, stabilizing at prices resulting from unlawful activity, and the prohibition of stabilization in ''at the market'' offerings. The Commission proposes to eliminate the distinction in Rule 10b–7 between exchange-traded and OTC securities.

Rule 104 would retain the exclusion for ''excepted securities.'' The Commission also proposes to expand the exception in Rule 10b–7 for distributions of Rule 144A-eligible foreign securities made solely to QIBs in exempt transactions. Rule 104 would except all distributions of Rule 144A-eligible securities to QIBs, and sales of Rule 144-eligible securities to non-U.S. persons, within the meaning of Regulation S under the Securities Act, that are made concurrently with Rule 144A distributions to QIBs. This responds to commenters who argued that as a matter of consistency, the exception for Rule 144A-eligible securities should be extended to the domestic context.

Rule 104 would eliminate the provision pertaining to limitation of liability. The Commission believes that lead managers now exert considerably more control over stabilizing transactions than when Rule 10b–7 was adopted, and that a provision regarding vicarious liability arising out of stabilizing transactions by syndicate members no longer appears necessary.

Q56. Does Rule 104 cover all situations where underwriters believe that stabilizing would be appropriate to facilitate an offering? Would the rule's greater flexibility result in stabilizing by underwriters in a greater number of instances?

Q57. In addition to ''at the market'' offerings, are there other categories of offerings (*e.g.*, best efforts) or securities (*e.g.*, penny stocks) for which stabilizing is not appropriate? Should issuers be permitted to stabilize and, if so, under what circumstances?

Q58. Is it appropriate to except from an anti-manipulation provision stabilization of offerings of Rule 144A-eligible securities?

Q59. Should the Commission retain the provision in Rule 10b–7(m) regarding limitation of liability? What purpose does this paragraph serve? If it should be retained, should it be in the same form as the current provision?

4. Aftermarket Activities

An underwriter's interest in the success of an offering does not necessarily end with the completion of the sales efforts and termination of formal stabilizing activities, but can extend into the ''aftermarket'' trading in the distributed security (in general, the period immediately following the termination of formal syndicate activity—the so-called ''breaking of the syndicate''). Aftermarket participation may be an expected part of the underwriting services provided to an issuer, and the anticipated quality of such services can influence the issuer's selection of a managing underwriter. Underwriters also have an incentive to provide ''support'' in the aftermarket to counterbalance pressure on the security's price from ''flipping'' and other selling activity that could adversely affect the investors who have purchased in the offering. In addition, the managing underwriter often purchases shares in the aftermarket period to cover a syndicate short position.[86] Accordingly, the point in time when underwriters no longer have the purpose to ''facilitate an offering'' cannot be identified with precision.

Furthermore, in initial public offerings the agreement among underwriters may contain a provision authorizing the managing underwriter to invoke a ''penalty bid.'' This is a contractual agreement permitting the managing underwriter to reclaim the selling concession accruing to a syndicate participant with respect to shares that the managing underwriter purchases in the aftermarket to cover the syndicate short position.[87] One of

[83] Rule 100 would define ''independent bid'' as a bid by a person who is not a distribution participant, issuer, selling securityholder, or affiliated purchaser.

[84] Rule 100 would define ''current exchange rate'' as the current rate of exchange between two currencies, which is obtained from at least one independent entity that provides foreign exchange quotations and information in the ordinary course of its business. Rule 104(g)(5) would retain Rule 10b–7's provisions that any stabilizing price that otherwise meets the requirements of the rule need not be adjusted to reflect special prices available to any group or class of persons (including employees or holders of warrants or rights). *See* 17 CFR 240.10b–7 (h), (i), (j)(5), and (j)(7).

[85] Unlike proposed Rules 101 and 102, which would apply to a ''distribution,'' Rule 104 would govern stabilizing to facilitate an ''offering,'' a term that is broader in scope.

[86] Underwriters frequently receive an overallotment option (commonly referred to as the ''Green Shoe'' option), which is the right, but not the obligation, to purchase securities from the issuer in addition to those initially underwritten by the syndicate, which may constitute up to 15% of the initial underwritten amount. Because the overallotment option may be insufficient to cover the entire syndicate short position, that portion in excess of the overallotment option must be covered through purchases in the secondary market.

[87] Penalty bids are governed by Schedule D of the NASD's By-Laws, Part V, Section 3, NASD Manual (CCH) ¶ 1820.

the primary objectives of a penalty bid is to encourage syndicate participants to sell the securities to those persons who intend to hold them rather than to engage in short-term profit-taking, *i.e.*, to combat flipping. Enforcement of penalty bids typically continues for as long as 30 days.

The Commission believes that the aftermarket activities described above are not uncommon and may act to support the price of the offered security in the aftermarket.[88] Commenters, however, were divided concerning whether regulation should be extended to cover such activities. Therefore, the Commission at this time is not proposing to extend the price limitations of Rule 104 to cover aftermarket activities. Instead, as described in the following section, the Commission is proposing to require disclosure of syndicate covering and penalty bid activities, and that underwriters keep records of such activities. Disclosure of these aftermarket activities would serve to apprise regulators of their possible market effects, while the recordkeeping requirements would assist the Commission in monitoring aftermarket practices and in assessing whether further regulation is warranted.

5. Disclosure and Recordkeeping

The Commission proposes to require more specific disclosure of stabilization, syndicate covering transactions,[89] and penalty bids[90] in order to make disclosure of these activities more meaningful.

Like Rule 10b–7, paragraph (h) of Rule 104 would require any person who places or transmits a bid that such person knows is for the purpose of stabilizing the price of any security to notify the market on which the transaction is effected, and to disclose the purpose of such transaction to the person to whom the bid is placed or is transmitted (*e.g.*, the specialist or the executing broker-dealer). The NASD requires persons intending to initiate stabilization to provide it with prior notification.[91] 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 recipients of the purpose of a bid by notifying the NASD. The exchanges, however, do not have this procedure. To fulfill the proposed requirements for stabilizing transactions on an exchange, underwriters would have to notify the exchange and provide disclosure separately to recipients of the bid. In the Commission's view, contemporaneous disclosure of the fact that stabilizing is occurring is beneficial to the market and its participants.

Rule 104 also would require any person effecting a syndicate covering transaction, or placing or transmitting a penalty bid, to disclose that fact to the SRO that has direct oversight authority over the market on which the syndicate covering transaction is effected, or the penalty bid is placed. This information would be helpful to the exchanges and Nasdaq in carrying out their surveillance responsibilities.

The stabilizing legend required by Rule 10b–7(k), and Item 502(d) of Regulations S–B and S–K,[92] 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,[93] governing the plan of distribution disclosure, would be revised 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. The objective of these proposals is to augment the language found in the stabilizing legend with more meaningful information regarding stabilizing and related activities.[94]

Q60. Is regulation of aftermarket transactions warranted? For example, should syndicate covering transactions be subject to the price level restrictions of Rule 104? Should penalty bids be prohibited as some commenters have suggested?

Q61. Would there be any difficulty in disclosing to the SRO the fact that syndicate covering transactions are occurring or that a penalty bid is in place?

Proposed amendments to Rule 17a–2 under the Exchange Act would require managing underwriters to keep records of syndicate covering transactions and penalty bids, in addition to stabilizing information. Records would reflect the name and class of securities, and the price, the date, and the time for each syndicate covering transaction. The records also would reflect the dates that any penalty bid was in effect, information relating to transactions against which penalty bids were assessed, and the date the bid was terminated. The information would be required to be maintained in a separate file, for a period of three years, the first two years in an easily accessible place. The Commission believes that this recordkeeping requirement will impose little, if any, additional burden on underwriters, because underwriters already are required to keep detailed syndicate account records.[95] Records of such transactions would provide the Commission with an empirical basis for determining whether additional regulation is warranted.

In addition to registered offerings for which a registration statement or a Form 1–A[96] is filed, Rule 17a–2 applies to any other offering if the total proceeds exceed $1,500,000. This threshold is proposed to be increased to $5,000,000 in Rule 17a–2. The Commission believes that raising this threshold would make the rule less burdensome for smaller offerings, and would be consistent with other Securities Act and Exchange Act initiatives.[97]

Q62. Is the expansion of Rule 17a–2 to include recordkeeping of syndicate covering transactions and penalty bids appropriate and what, if any, burdens would be imposed by these new requirements?

Q63. Should offerings with proceeds of $5,000,000 or less be exempt from Rule 17a–2?

*F. Rule 105—Short Sales In Connection With An Offering*

The Commission adopted Rule 10b–21 in 1988 to address the practice of manipulative short sales prior to a public offering by short sellers who cover their short positions by purchasing securities in the offering. Manipulative short sales could result in a lower offering price, and thus reduce

[88] *See* J. Shayne & L. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 Vand. L. Rev. 965, 983–84 (May 1995).

[89] Rule 100 would define ''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.

[90] Rule 100 would define ''penalty bid'' to mean an arrangement that permits the managing underwriter to reclaim a selling concession otherwise accruing to a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.

[91] *See* Schedule D of the NASD's By-laws, Part V, Section 3(c), *NASD Manual* (CCH) ¶ 1820.

[92] *See* 17 CFR 228.502(d) and 229.502(d).

[93] *See* 17 CFR 228.508 and 229.508.

[94] Once a ''plain English'' prospectus is implemented, a stabilizing legend may no longer be required on the inside front cover of the prospectus. *See* Task Force Report at 17–18, *supra* note 13.

[95] *See* NASD Rules of Fair Practice, Art. III, Sec. 21, *NASD Manual* (CCH) ¶ 2171. *See also* NASD Rules of Fair Practice, Art. III, Sec. 44, *NASD Manual* (CCH) ¶ 2200D.

[96] 17 CFR 249.1a.

[97] *See, e.g.*, Securities Exchange Act Release No. 35895 (June 27, 1995), 60 FR 35642.

proceeds to the issuer. Rule 10b–21 addresses this practice by prohibiting the covering from the offering of any short sales made during the period beginning at the time a registration statement or Form 1–A is filed and ending at the time that sales may be made pursuant to the registration statement or Form 1–A.

The Commission is proposing Rule 105 to replace Rule 10b–21. Rule 105, like Rule 10b–21, is designed to prevent short sales from being covered with securities obtained from an underwriter, broker, or dealer who is participating in the offering. Rule 105 would differ from Rule 10b–21 because it would cover only those short sales effected in the period commencing five business days prior to the pricing of an offering and ending with such pricing. Reducing the period of the rule's applicability is consistent with the structure of Rules 101 and 102, which provide for shorter restricted periods, and reflects the Commission's belief that such period should be sufficient to dissipate the effects of any manipulative short selling on the price of the offered security.

Commenters expressed divided views on the efficacy of Rule 10b–21. Some believe that the rule impedes legitimate short selling activity. Others maintain that the rule would be more effective if it also covered activity in derivative securities. Since the adoption of Rule 10b–21, several additional regulatory measures have been implemented that may lessen the effects of short selling in connection with an offering. These initiatives, which include permitting passive market making during offerings of Nasdaq securities and implementing a short sale rule for the Nasdaq market,[98] may reduce the need for Rule 105. Short selling to depress an offering price would continue to be covered by the general anti-manipulation provisions of the Securities Act and the Exchange Act.

Q64. Does a special regulation dealing with short selling in connection with an offering continue to be necessary or appropriate?

Q65. Should the prohibitions of Rule 105 extend to short sales of derivative securities? Commenters should discuss how this proposal would be consistent with Rule 101, which would not cover bids or purchases of derivative securities.

Q66. Would the five business day restricted period present compliance difficulties?

Q67. Should the restricted period of Rule 105 parallel the one or five business day restricted periods of Rule 101, which depend on the security's ADTV?

Q68. Should offerings of actively-traded securities (*i.e.*, securities having an ADTV value of at least $1 million) be excluded from Rule 105, as in Rule 101?

## IV. Safe Harbor Alternative

Many commenters endorsed recasting the rules as non-exclusive safe harbors from the statutory anti-manipulation provisions of the Exchange Act.[99] They argued that Rule 10b–6 can have a disproportionate impact on those distribution participants and affiliated purchasers who inadvertently run afoul of the rule's prohibitions but do not affect the offered security's price.

The Commission believes that a prophylactic approach to market activities of persons interested in a distribution continues to serve an important role in maintaining the integrity of the capital markets. In the Commission's view, the framework of proposed Regulation M preserves the Commission's strong interest in protecting investors from manipulated offerings, while providing flexibility, clarity, and guidance to offering participants.

The Commission has stated that the ''exceptions [to Rule 10b–6] are not, and never have been, safe harbors,'' and that a lack of improper motive when relying on the rule's exceptions always has been required.[100] A safe harbor from manipulation charges is inappropriate in contexts where it is reasonable to infer that manipulative incentives are present, such as during securities distributions. Also, requiring the Commission to demonstrate the existence of a purpose on the part of persons engaged in any market activity, for example, to ''facilitate the distribution'' of an offered security,[101] would conflict with the goal of precluding improper market activity prior to pricing of offerings. The inclusion of a ''purpose'' element effectively would make enforcement of such a provision an after-the-fact remedy that would in many respects overlap Rule 10b–5. Moreover, it is likely that safe harbor rules would be inappropriate for some securities offerings, such as those involving penny stocks, and may be inconsistent with the Commission's express statutory authority to promulgate rules governing the ''pegging, fixing, or stabilizing'' of the price of certain securities.[102]

It is important to note, moreover, that commenters advocated a safe harbor approach in the context of the current rules. As proposed, several categories of offerings, persons, and activities that are subject to the trading practices rules would not be subject to the prophylactic prohibitions of Regulation M. In addition, the new rules would create a more flexible framework for conducting market activities during distributions. The proposed exception for *de minimis* violations would address the concerns commenters had regarding the impact of Rule 10b–6 on those persons who inadvertently violated the rule through nominal purchases, or unaccepted bids.

Although the Commission does not favor a safe harbor approach, commenters may wish to present arguments supporting a safe harbor framework and to submit draft rule text. Commenters are urged to provide careful analyses of how a safe harbor approach would be utilized and what kinds of transactions would be permitted under a safe harbor. Would safe harbor rules be appropriate in all contexts and, if not, would it be confusing to have a set of safe harbor and prophylactic rules governing substantially similar conduct?

The Commission also requests comment as to whether a safe harbor approach to anti-manipulation regulation would diminish the investor protection goals of the Exchange Act. How would the balance between the capital-raising role of securities offerings and the Commission's investor protection mandate be affected if a safe harbor were extended to the general anti-manipulation provisions?

Support for the safe harbor approach also appears to stem from concerns regarding application of the general anti-manipulation provisions to conduct that would be permitted under the trading practices rules. The Commission requests comment on alternatives to a safe harbor approach that might address uncertainty regarding the reach of the general anti-manipulation provisions in circumstances where the conduct in question otherwise would be permitted under Regulation M. For example, should conduct in compliance with Regulation M be presumed not to violate the general anti-manipulation provisions, subject, of course, to rebuttal?

## V. General Request for Comments

Any interested person wishing to submit written comments on any aspect

[98] NASD Rules of Fair Practice, Art. III, Sec. 48, *NASD Manual* (CCH) ¶ 2200H.

[99] Commenters cited Rule 10b–18 as a relevant example of a safe harbor provision. *See supra* Section III.C.6. discussing Rule 10b–18.

[100] *See* Securities Exchange Act Release No. 24003 (January 16, 1987), 52 FR 2994, 2998.

[101] This is a component of the ABA draft proposal.

[102] *See* Section 9(a)(6) of the Exchange Act.

of the proposed rules discussed in this release, as well as on other matters that might have an impact on the proposals contained herein, is requested to do so. In addition to the comments solicited above, commenters are urged to provide their views on the overall structure of proposed Regulation M and whether the format and the rules contained herein provide a beneficial alternative to the trading practices rules. Commenters are encouraged to submit proposed rule text and data together with their written comments. Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, and should refer to file number S7–11–96. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov., and should include the file number on the subject line of the E-mail.

## VI. Costs and Benefits of the Proposed Amendments and Their Effects on Competition

To assist the Commission in its evaluation of the costs and benefits that may result from the proposed new rules, commenters are requested to provide analyses and data relating to costs and benefits associated with any of the proposals herein. The Commission preliminarily believes that compliance burdens generally will be reduced by the proposed changes. The proposals would reduce significantly trading restrictions on issuers, underwriters, and others with an interest in an offering from those currently in effect and, therefore, should reduce the costs of raising capital.

In addition, Section 23(a)(2) of the Exchange Act requires the Commission, in adopting rules under the Exchange Act, to consider the anti-competitive effects of such rules, if any, and to balance any impact against the regulatory benefits gained in terms of furthering the purposes of the Exchange Act.[103] The Commission preliminarily has considered the proposed rules in light of the standards cited in Section 23(a)(2) and believes preliminarily that, if adopted, they would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act. Indeed, the Commission believes that Regulation M may enhance the posture of U.S. underwriters in relation to foreign broker-dealers in competing for underwriting business in cross-border distributions. The Commission solicits commenters' views regarding the effects of the proposed rules on competition.

## VII. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA''), in accordance with the provisions of the Regulatory Flexibility Act,[104] regarding the rules contained in proposed Regulation M and the proposed amendments to Rules 10b–18 and 17a–2 under the Exchange Act and Items 502(d) and 508 of Regulations S–B and S–K.

As discussed more fully in the analysis, some of the issuers and broker-dealers that Regulation M would affect are small entities, as defined by the Commission's rules. In general, Regulation M overall would decrease costs for issuers and broker-dealers participating in an offering, including small businesses.

The analysis discusses the types of possible alternative proposals that the Commission has considered. These include, among others, the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities, and whether such entities could be exempted from any of the proposed rules, or any part thereof. Because small entities will benefit from the less restrictive nature of Regulation M, the Commission does not believe that any of the alternatives are preferable to the rules as proposed. Small issuers will benefit from the changes to the eligibility criteria for Nasdaq passive market making and small broker-dealers will benefit from the 100 share minimum net purchasing capacity provided for all passive market makers. The Commission believes that Regulation M balances the objective of a simplified, streamlined, more flexible regulation with its statutory mandate of investor protection in a manner more appropriate than other alternatives.

In the IRFA, the Commission encourages the submission of written comments with respect to any aspect of the IRFA. Those comments should specify costs of compliance with the new rules, and suggest alternatives that would accomplish the objectives of modernizing and streamlining the Commission's trading practices rules.

A copy of the IRFA may be obtained from 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, (202) 942–0772.

## VIII. Paperwork Reduction Act

Certain provisions of proposed Regulation M contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995,[105] and the Commission has submitted them to the Office of Management and Budget for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information is: ''Proposed Regulation M.''

### *A. Collection of Information Under Regulation M*

Proposed Regulation M would require information collection in two general areas. First, various provisions of Regulation M would require persons participating in a distribution to collect certain information to comply with, or to take advantage of certain exceptions under, Rules 101 or 102 or to comply with Rule 103. Second, Rule 104 and related amendments would require disclosure and recordkeeping of persons engaged in stabilization and certain aftermarket activities.

#### 1. Rules 101, 102, and 103

Rules 101 and 102 would require the ADTV to be calculated using the three full consecutive calendar months preceding the filing of the registration statement (or preceding pricing if there is no registration statement or a shelf distribution is involved) to determine which restricted period applies, or whether the security is excepted from the rule. Because the *de minimis* exception to Rule 101 is available for purchases of up to one percent of the security's ADTV, the ADTV calculation also may be made by a distribution participant seeking to take advantage of this exception. To determine which restricted period must be used, or to rely on the actively-traded securities exception or *de minimis* exception, a distribution participant would need to examine publicly available market data to calculate the ADTV. The Commission believes that the syndicate manager would advise other distribution participants of the ADTV of the particular security being distributed. Additionally, the Commission has requested comment on whether prospectus disclosure is necessary to inform investors about the potential market activities of persons relying on the actively-traded securities exception from Rule 101.

Rule 102 would require issuers and selling securityholders to calculate the security's ADTV to determine the appropriate restricted period. In this

[103] *See* 15 U.S.C. 78w(a)(2).

[104] 5 U.S.C. 603.

[105] 44 U.S.C. 3501 *et seq.*

case, the Commission believes that the syndicate manager would provide the security's ADTV to the issuer or selling securityholders. In a small number of self-underwritten offerings, issuers may calculate the ADTV. Rule 103 would employ the notion of ''Nasdaq ADTV,'' which is defined as the average daily trading volume of the security accounted for by a particular market maker, as obtained from the NASD. As the owner and operator of Nasdaq, the NASD has access to this information, and now provides that information to the syndicate manager.

The proposed definition of affiliated purchaser in Regulation M reflects the increasingly complex structure of financial and other conglomerates by recognizing the structural separations and information barriers between distribution participants and their affiliates. Regulation M would provide an exception to the proposed definition of affiliated purchaser where certain information barriers exist. This exception would require the participant to establish, maintain, and enforce written policies and procedures to segregate the flow of information between itself and its affiliates. A distribution participant relying on this exception also would be required to obtain an independent assessment of the operation of its policies and procedures governing its information barriers during any calendar year in which it participates in a distribution.

Rule 101 would provide an exception for *de minimis* violations during the restricted period. This provision would except purchases of less than one percent of the ADTV of the security in distribution. However, this provision is only available where the person making such bid or purchase subject to the exception has established, maintains, and enforces written policies and procedures reasonably designed to achieve compliance with the other provisions of Rule 101.

Rule 103 would require passive market makers to notify the NASD in writing that it intends to conduct passive market making. Rule 103 also would require the disclosure required pursuant to Items 502 and 508 of Regulations S–B and S–K with respect to the intended passive market making activities. This disclosure is required under Rule 10b–6A. Because Rule 103 extends the availability of passive market making to offerings of securities that previously were ineligible, it potentially would increase the number of respondents submitting such information for passive market making purposes.

2. Rule 104

Proposed Rule 104 would require disclosure of stabilizing activities in the offering materials and would expand information collection with respect to certain aftermarket activities. In addition, Rule 104 would require any person who places or transmits a bid that such person knows is for the purpose of either stabilizing the price of any security to disclose the purpose of such transaction to the market. Any person placing or transmitting a stabilizing bid also would be required to disclose the bid's purposes to the person to whom the bid is placed or transmitted. In the case of syndicate covering transactions and penalty bids, disclosure must be made to the appropriate SRO. Proposed revisions to Rule 17a–2 under the Exchange Act would require underwriters to keep records of syndicate covering transactions and penalty bids, in addition to stabilizing information.

The stabilizing legend required by paragraph (k) of Rule 10–b7, and Item 502(d) of Regulations S–B and S–K would be replaced by a short legend briefly indicating, in plain language, the transactions that may affect the offered security's price and directing investors to a further discussion of these transactions in the ''plan of distribution'' section of the prospectus. Furthermore, Item 508 of Regulations S–B and S–K governing the plan of distribution disclosure, would be revised 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 marketplace. Although these proposed amendments are directed to Items 502(d) and 508 of Regulations S–B and S–K, the actual paperwork burden results from preparing the Commission forms that reference these items, such as Forms S–1, S–2, and S–3 under the Securities Act.[106]

*B. Proposed Use of the Information*

The information collected pursuant to proposed Regulation M would be used by the Commission, SROs, or investors. The information required pursuant to Rule 17a–2, however, would be maintained solely in the syndicate managers' records, to which the Commission would have access upon request. The Commission would not regularly receive any of the information described above, other than through the filing of registration statements that contain the information in Items 502(d) and 508 of Regulations S–B and S–K.

The notice provided to the NASD pursuant to proposed Rule 103 would serve to alert the NASD that members of the underwriting syndicate may engage in passive market making. Reporting passive market making purchases to the NASD would further assist in its surveillance of passive market making, which is an integral component of passive market making. The Commission would not receive copies of the notices provided to the NASD. Disclosure in the prospectus that the underwriters may engage in passive market making would alert the investors of such potential activity to assist in their investment decisions.

Notifying the market of stabilizing bids, and the SRO of syndicate covering transactions or penalty bids, would provide the market or SRO with information on transactions that may affect the price of the security.

The Commission would use records required pursuant to Rules 104 and related Rule 17a–2 in examinations or investigations of underwriting activities, and for general regulatory oversight. This information may be requested or reviewed by the Commission in connection with its regulatory and enforcement responsibilities. Investors would use the disclosure required in Rule 104 and Items 502(d) and 508 of Regulations S–B and S–K to evaluate a security for investment purposes in light of possible stabilizing and related activities.

*C. Respondents*

The exclusion from the coverage of Rule 101 for certain affiliates of a distribution participant, when information barriers are established, may be used by every distribution participant. The Commission does not have information on the number of broker-dealers who participate in distributions or on the number of such broker-dealers who have affiliates and would seek to take advantage of this exception. The Commission estimates that the number of respondents in this category would be 100.

The exclusion available for *de minimis* violations of Rule 101 would be available to all distribution participants that maintain a written policy for compliance with Regulation M. The Commission does not have information on the number of broker-dealers who participate in distributions. The Commission estimates that the number of respondents in this category would be 100. To use the actively-traded securities exception or to calculate the restricted periods under Rules 101 and

[106] 17 CFR 239.11, 239.12, and 239.13, respectively.

102, or to engage in aftermarket activities under Rule 104, the Commission believes that the syndicate manager of each relevant offering would collect the required information. Over the past five years, there have been an average of 522 firm commitment offerings per year. In addition, the Commission believes that in approximately 50 self-underwritten offerings per year the issuer would calculate the ADTV.

*D. Total Annual Reporting and Recordkeeping Burden*

1. Restricted Periods

For each of the estimated 522 firm commitment, public offerings per year, the Commission believes it would take approximately one hour for the managing underwriter to calculate the ADTV, determine the applicable restricted period, and inform other distribution participants, if any. Approximately 522 hours would be required annually for these calculations. In addition, approximately 50 hours would be required annually for issuers to calculate the ADTV for self-underwritten offerings. In many circumstances, however, the collection of information would be unnecessary because satisfaction of the condition would be self-evident (*i.e.,* the ADTV would be extremely high or extremely low).

2. Information Barriers

The Commission estimates that approximately 100 broker-dealers that act as distribution participants in offerings covered by Regulation M may seek to except the activities of an affiliate from the regulations. The Commission estimates that the written policy required for the exemption would take approximately 40 hours to draft and implement. The Commission estimates that the annual audit would take approximately 10 hours. Approximately 4,000 hours would be required by this exemption in the first year and approximately 1,000 hours in each subsequent year. The Commission believes, however, that this policy creating the information barrier would be subsumed under the policies and procedures already put in place by broker-dealers participating in offerings for the purpose of complying with other federal and state securities laws.

3. De Minimis Exception

The Commission estimates that approximately 975 broker-dealers annually will act as distribution participants in offerings covered by Regulation M. The Commission estimates that the written policy required for the *de minimis* exception would take approximately 40 hours to draft and implement. Approximately 39,000 hours would be required by this exemption in the first year.

4. Rule 103

In every firm commitment offering of Nasdaq securities, the underwriters may seek to engage in passive market making. In 1995, 155 Nasdaq offerings involved passive market making pursuant to Rule 10b–6A. The managing underwriter would inform the NASD, receive the data, and inform the syndicate members of their passive market making status. The Commission estimates that the written notice required to be provided to the NASD would involve one hour of preparation. Rule 103, however, makes the passive market making exemption available for a greater number of transactions. There were a total of 375 secondary offerings of Nasdaq securities in 1995, most of which, but not all of which, could have used passive market making under proposed Rule 103. Assuming 375 is a reasonable number of offerings in a typical year and assuming that passive market making would be available under Rule 103 for all of these offerings, the Commission estimates that the total burden of Rule 103 would be 375 hours.

5. Stabilizing and Aftermarket Activities

a. Disclosure of Stabilizing Bids to the Market

The Commission does not have a reasonable basis upon which to estimate how frequently this disclosure will be required because stabilizing bids rarely occur. In all instances where such disclosure would be required, the Commission estimates that it would require 15 minutes.

b. Notice of Penalty Bid

The Commission estimates that disclosing penalty bids would require six minutes per offering. Using 522 offerings, as discussed above, this disclosure would require an estimated 52 hours over the course of a year.

6. Rule 17a–2

The Commission estimates that creating and maintaining records pursuant to this rule would require five hours per offering. Because most of the records required pursuant to this rule already are retained as a matter of practice, the Commission believes that its time estimate should not impose burdens much greater than already exist with respect to Rule 17a–2. Using 522 offerings, as discussed above, this recordkeeping would require an estimated 2,610 hours over the course of a year.

7. Items 502 and 508

The Commission estimates that the disclosure required by the changes to Items 502(d) and 508 of Regulations S–B and S–K would require 30 minutes per firm commitment offering. The Commission expects that this burden will be reduced significantly as respondents become more familiar with the disclosure. If the respondents using Forms S–1, S–2, S–3, S–11, SB–1, SB–2, F–1, F–2, and F–3, which incorporate the disclosure required by Items 502(d) and 508, each conducted a firm commitment offering, disclosing this information would require an estimated 2,391 hours per year.

*E. General Information About the Collection of Information*

Any collection of information under Regulation M would be a voluntary action to avoid the otherwise prophylactic measures of the rules thereunder. Only Rule 17a–2 imposes a three-year retention period on the collected information. None of the other rules prescribe retention periods. In general, the information collected pursuant to Regulation M would be held by the respondent. The Commission would only gain possession of the information upon its request. Any information collected pursuant to Regulation M would not be confidential and would be publicly available from sources other than the respondent.

*F. Request for Comment*

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

(i) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility;

(ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information;

(iii) enhance the quality, utility, and clarity of the information to be collected; and

(iv) minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms for information technology.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, D.C. 20503, and

should also send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, and refer to File No. S7–11–96. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release in the Federal Register, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of this publication.

IX. Statutory Basis and Text of Proposed Rules and Amendments

The proposed amendments to Rules 10b–6, 10b–6A, 10b–7, 10b–8, 10b–18, 10b–21, and 17a–2 would be 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 proposed amendments to Items 502(d) and 508 of Regulations S–B and S–K would be 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, 78*l*, 78m, 78n, 78o, 78p, and 78w; and the Investment Company Act of 1940, 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 would be 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), 78*l*, 78m, 78n, 78o(c), 78o(g), 78q(a), 78w(a), and 78dd–1; and the Investment Company Act of 1940, 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.

List of Subjects

*17 CFR Part 228*

Reporting and recordkeeping requirements, Securities, Small businesses.

*17 CFR Part 229*

Reporting and recordkeeping requirements, Securities.

*17 CFR Part 240*

Broker-dealers, Confidential business information, 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 proposed to be amended as follows:

## PART 228—INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

1. 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, 78*l*, 78m, 78n, 78o, 78w, 78*ll*, 80a–8, 80a–29, 80a–30, 80a–37, 80b–11, unless otherwise noted.

2. Section 228.502 is amended by revising the introductory text of paragraph (d)(1) and paragraph (d)(1)(i) to read as follows:

**§ 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.''

* * * * *

3. Section 228.508 is amended by adding paragraph (j) to read as follows:

**§ 228.508 (Item 508) Plan of distribution.**

* * * * *

(j) *Stabilizing and other transactions.* If the underwriters or any selling group members intend 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

4. 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, 78*l*, 78m, 78n, 78o, 78w, 78*ll*(d), 79e, 79n, 79t, 80a–8, 80a–29, 80a–30, 80a–37, 80b–11, unless otherwise noted.

* * * * *

5. Section 229.502 is amended by revising the introductory text of paragraph (d)(1) and paragraph (d)(1)(i) to read as follows:

**§ 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.''

* * * * *

6. Section 229.508 is amended by adding paragraph (l) to read as follows:

**§ 229.508 (Item 508) Plan of distribution.**

* * * * *

(l) *Stabilizing and other transactions.* If the underwriters or any selling group members intend 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 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

7. 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, 78i, 78j, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78*ll*(d), 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

8. Section 240.10b–6 is removed and reserved.

9. Section 240.10b–6A is removed.

10. Sections 240.10b–7 and 240.10b–8 are removed and reserved.

11. 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 a distribution (as defined in § 242.100 of this chapter) of such stock, or a distribution for which such 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;

* * * * *

12. Section 240.10b–21 is removed and reserved.

13. 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 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 to facilitate an offering of any security (other than an ''exempted security,'' as hereinafter defined); or effects a purchase that is a ''syndicate covering transaction,'' as defined in § 242.100 of this chapter; or places or transmits 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.*);

(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 placing or transmitting a penalty bid for his sole account or for the account of a syndicate or group in which he 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 places or transmits a penalty bid shall:

(1) Promptly record and maintain in a separate file, for a period of not less than three years, the first two years in an accessible place, the following information:

(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 invoked;

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

(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 and the transactions against which any penalties were assessed.

* * * * *

(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 his 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, for a period of not less that three years, the first two years in an easily accessible place.

14. Part 242 is added to read as follows:

## PART 242—REGULATION M

Sec.

242.100 Definitions.
242.101 Activities by distribution participants.
242.102 Activities by issuers or selling securityholders 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), 78*l*, 78m, 78n, 78o(c), 78o(g), 78q(a), 78q(h), 78w(a), 78dd–1, 80a–23, 80a–29, 80a–37.

**§ 242.100 Definitions.**

For purposes of this section, the following definitions shall apply:

*Affiliated purchaser* means:

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

(2) An affiliate who, directly or indirectly, controls the purchases of such securities by a distribution participant, issuer, or selling securityholder, whose purchases are controlled by any such person, or whose purchases are under common control with any such person; or

(3) An affiliate of a distribution participant, issuer, or selling securityholder 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; *Provided, however,* That this paragraph (3) shall not apply to an affiliate of a distribution participant where the following conditions are satisfied:

(i) The affiliate is a separate and distinct organizational entity from the distribution participant, with no officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel) in common with the distribution participant;

(ii) The affiliate's bids for, purchases of, and inducements to purchase the securities subject to this section are made in the ordinary course of its business; and

(iii) The distribution participant:

(A) Establishes, maintains, and enforces written policies and procedures to segregate the flow of information between itself and its affiliates that might result in activity prohibited by § 242.101(a); and

(B) Obtains an independent assessment of the operation of such policies and procedures during any calendar year in which it participates in a distribution.

*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 times when, or the prices at which, the independent agent may purchase the issuer's securities for the plan, the amounts of the securities to be purchased, 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 the plan or the basis for determining the frequency of its allocations to the plan, or any formula specified in the plan that determines the amount of securities to be purchased by the agent.

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

*Average daily trading volume* means the world-wide reported average daily trading volume during the three full consecutive 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, three full consecutive calendar months immediately preceding the pricing. The value of average daily trading volume means the average trading volume multiplied by the security's price in U.S. dollars as of the last day of the most recent month.

*Business day* refers to a twenty-four hour period determined with reference to the principal market for the securities to be distributed, and that includes a complete trading session for that market.

*Completion of participation in a distribution.* A person shall be deemed to have completed its participation in a distribution as follows:

(1)(i) An issuer, when the distribution is completed; and

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

(iii) Any other person, when such person's participation has been distributed.

(2) A person shall be deemed to have distributed securities acquired by such person for investment.

*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 foreign exchange quotations and information 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.

*Eligible security* means a Nasdaq security that is the subject of a distribution, other than an at the market offering or conducted other than on a best efforts basis, or is the reference security for such security.

*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 securityholder, or affiliated purchaser.

*NASD* means the National Association of Securities Dealers, Inc.

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

*Nasdaq ADTV* means the average daily trading volume in an eligible security during the reference period, as obtained from the NASD.

*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.

*Passive market maker* means a market maker that effects transactions in accordance with the provisions of § 242.103(b).

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

*Plan* consists of any bonus, profit-sharing, pension, retirement, thrift, savings, incentive, stock purchase, stock option, stock ownership, stock appreciation, dividend reinvestment, or similar plan of an issuer or its subsidiaries; or any dividend or interest reinvestment plan or employee benefit plan as defined in § 230.405 of this chapter. For purposes of this paragraph and § 242.102(c) only, the term ''employee'' has the meaning contained in Form S–8 (§ 239.16b of this chapter) relating to employee benefit plans.

*Principal market* means the single securities market with the largest aggregate reported trading volume for the class of securities in the shorter period of the preceding twelve full consecutive calendar months or the period since the issuer's incorporation. 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. For purposes of this paragraph, reported refers to prices of securities that are reported pursuant to § 240.11Aa3–1 of this chapter or that are reported to a foreign financial regulatory authority as defined in section 3(a)(52) of the Exchange Act (15 U.S.C. 78c(a)(52)).

*Prospective underwriter* means a person:

(1) Who has submitted a bid to the issuer or other person on whose behalf the distribution is to be made, and knows or reasonably expects 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 reasonably expects to reach, an understanding with the issuer, selling securityholder, or managing underwriter that such person will become an underwriter, whether or not the terms and conditions of the underwriting have been agreed upon.

*Reference period* means the three full consecutive 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, three full consecutive calendar months preceding the pricing.

*Reference security* means a security whose price is, or may in the future be, used to determine, in whole or in significant part, the value of a security that is the subject of a distribution.

*Restricted period* means the period beginning:

(1) For any security with an ADTV value of $100,000 or more, on the later of one business day prior to the determination of the price of the security to be distributed or such time that a person becomes a distribution participant, and ending upon the completion of such person's participation in the distribution; or

(2) For all other securities, on the later of five business days prior to the determination of the price of the securities to be distributed or such time that a person becomes a distribution participant, and ending upon the completion of such person's participation in the distribution.

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

*Selling securityholder* means any person on whose behalf a distribution is made, other than the issuer.

*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 syndicate short position.

*30% ADTV Limit* means 30 percent of the market maker's Nasdaq ADTV.

*Transaction* means a bid or a purchase.

*Underwriter* means a person who has agreed with an issuer or selling securityholder:

(1) To purchase securities for distribution; or

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

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

**§ 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 to attempt to induce any person to bid for or purchase a covered security during the applicable restricted period.

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

(1) *Research.* The publication or dissemination, in the ordinary course of business, 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

(4) *Exercises of securities.* The exercise of any option or warrant, any right received in connection with a rights offering, or any right or conversion privilege set forth in the instrument governing a security to acquire any security directly from the issuer; or

(5) *Unsolicited brokerage.* Unsolicited brokerage transactions; or

(6) *Basket transactions.* (i) Transactions in connection with a basket of securities in which the security that is the subject of the distribution does not comprise more than five percent of the value of the basket purchased and such basket contains a minimum of 20 securities; or

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

(7) *De minimis transactions.* Purchases of less than one percent of the average daily trading volume of the security, or unaccepted bids; *Provided, however,* That the person making such bid or purchase has established, maintains, and enforces written policies and procedures reasonably designed to achieve compliance with the other provisions of this section; or

(8) *Transactions in connection with the distribution.* (i) Transactions among distribution participants in connection with the distribution, or purchases of securities from an issuer or selling securityholder necessary to conduct the distribution, effected otherwise than on a securities exchange or through an inter-dealer quotation system; and

(ii) 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 to sell or solicitation of offers to buy; or

(9) *Distributions of 144A securities.* Transactions in securities eligible for resale under § 230.144A(d)(3) of this chapter, if:

(i) Such securities are offered or sold in the United States solely to 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) During a distribution qualifying under paragraph (b)(9)(i) of this section, such securities are offered or sold concurrently to persons not deemed to be ''U.S. persons'' for purposes of §§ 230.902(o)(2) or 230.902(o)(7) of this chapter.

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

(1) *Actively-traded securities.* Securities with an ADTV value of at least $1 million; or

(2) *Investment grade nonconvertible securities.* Nonconvertible debt securities or nonconvertible preferred securities; *Provided, however,* That at least one nationally recognized statistical rating organization, as that term is used in § 240.15c3–1 of this chapter, has rated the nonconvertible securities being distributed 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 securities 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 to any transaction or transactions, either unconditionally or on specified terms and conditions.

**§ 242.102 Activities by issuers and selling securityholders during a distribution.**

(a) Unlawful Activity. In connection with a distribution of securities, it shall be unlawful for an issuer, selling securityholder, or an affiliated purchaser of such person, directly or indirectly, to bid for, purchase, or to attempt to induce any person to bid for

or purchase a covered security during the applicable restricted period.

(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

(2) *Transactions complying with § 270.23c–3.* Transactions complying with § 270.23c–3 of this chapter; or

(3) *Exercises of securities.* The exercise of any option or warrant, any right received in connection with a rights offering, or any right or conversion privilege set forth in the instrument governing a security to acquire any security directly from the issuer; or

(4) *Transactions in connection with the distribution.* Offers to sell or the solicitation of offers to buy the securities being distributed.

(c) Plans. (1) Paragraph (a) of this section shall not apply to distributions of securities by or on behalf of an issuer or a subsidiary of an issuer pursuant to a plan, which are made:

(i) Solely to employees or securityholders of the 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 securityholders, if bids for or purchasers of securities pursuant to such plan are effected solely by an agent independent of the issuer and the securities are from a source other than the issuer.

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

(2) *Face-amount securities 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)(2) 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 to any transaction or transactions, either unconditionally or on specified terms and conditions.

**§ 242.103 Nasdaq passive market making.**

(a) Scope of Section. This section permits broker-dealers to engage in market making transactions in eligible securities without being in violation of the provisions of § 242.101, except when a stabilizing bid for such security is in effect pursuant to § 242.104.

(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. Except as provided below, a passive market maker shall not display a bid for or purchase an eligible security at a price that exceeds the highest independent bid for the eligible security at the time of the transaction; *Provided, however,* That a passive market maker may purchase an eligible security at a price that exceeds the highest independent bid for such security at the time of the transaction to comply with a rule promulgated by the Commission or NASD governing the execution of customer orders.

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

(3) *Purchase limitation.* On each day, a passive market maker's net purchases shall not exceed its 30% ADTV Limit; *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 30% ADTV Limit being equalled or exceeded. If a passive market maker's net purchases equal or exceed its 30% ADTV Limit, it shall immediately withdraw its quotations from Nasdaq, and it may not effect any transaction in the eligible security for the remainder of that day, irrespective of any additional sales during that day, unless otherwise permitted by § 242.101.

(4) *Limitation on displayed size.* At all times, the passive market maker's displayed bid size may not exceed the smaller of the minimum quotation size for the eligible security, or the passive market maker's remaining purchasing capacity under this paragraph (b)(4); *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 writing in advance of its intention to engage in passive market making. A passive market maker 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 eligible 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 Act, the Exchange Act, 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 effect any stabilizing transaction or any syndicate covering transaction or to place or transmit a penalty bid in connection with an offering of any security, in contravention of the provisions of this section.

(b) Purpose. No stabilizing transaction shall be made 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) Stabilizing at Prices Resulting from Unlawful Activity. 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 Act, the Exchange Act, or any rule or regulation thereunder.

(f) Stabilizing Prohibited in at the Market Offerings. No person shall stabilize any at the market offering.

(g) Stabilizing Levels.

(1) *No stabilizing above offering price.* No stabilizing shall be effected in a security at a price above the offering price. If stabilizing is effected before the initial public offering price is determined, and such offering price is higher than the stabilizing bid or purchase price, then stabilizing may be resumed after determination of the public offering price at the price at which stabilizing could then be effected.

(2) *Stabilizing when the principal market is open.* Except as limited by the other provisions of this paragraph (g), no stabilizing shall be effected in any market at a price higher than the stabilizing bid in the principal market for the security, or, if there is no stabilizing bid in the principal market, the highest independent bid for the security in its principal market.

(3) *Stabilizing when the principal market is closed.* Except as limited by the other provisions of this paragraph (g), before the opening of quotations for the security in the market where stabilizing will be effected, no stabilizing shall be effected at a price in excess of the lower of:

(i) The price at which stabilizing could have been effected at the close of the principal market; or

(ii) 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. After the opening of quotations in the market where stabilizing will be effected, no stabilizing shall be effected at a price higher than the highest independent bid for such security in that market.

(4) *Adjustments to stabilizing price.* (i) A stabilizing bid may be increased to a price no higher than the price at which stabilizing could then be lawfully initiated. A stabilizing bid that is lawful under this section when initiated may be maintained continuously or reduced irrespective of changes in the independent bid of the security.

(ii) If a security goes ex-dividend, ex-rights, or ex-distribution, the price at which such security is being stabilized shall be reduced by an amount equal to the value of the dividend, right, or distribution. 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. If, in entering, maintaining, or adjusting a bid pursuant to this paragraph (g)(4), the adjusted bid would be at or below the midpoint between two trading differentials, such stabilizing bid shall be adjusted downward to the lower differential.

(5) *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).

(h) Disclosure and Notification. (1) Any person placing or transmitting a bid that such person knows is for the purpose of stabilizing the price of any security shall provide prior notice of such transaction to the market on which such transaction is effected, and disclose the purpose of such transaction to the person with whom the bid is placed or is transmitted.

(2) Any person effecting a syndicate covering transaction or placing or transmitting a penalty bid shall provide prior notice of such syndicate covering transaction or penalty bid to the self-regulatory organization with direct authority over the market on which such syndicate covering transaction is effected or such penalty bid is placed or transmitted.

(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 or where a syndicate covering transaction may be or has been effected for such security or where a penalty bid may be or has been in effect, shall give the purchaser at or before the completion of the transaction, a prospectus, offering circular, confirmation, or other writing 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 any of the following securities:

(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) *Rule 144A eligible securities.* Any distribution of securities eligible for resale under § 230.144A(d)(3) of this chapter, if:

(i) Such securities are offered or sold in the United States solely to 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) During a distribution qualifying under paragraph (j)(2)(i) of this section, such securities are offered or sold concurrently to persons not deemed to be ''U.S. persons'' for purposes of §§ 230.902(o)(2) or 230.902(o)(7) of this chapter.

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

**§ 242.105 Short selling in connection with a public offering.**

(a) Unlawful Activity. In connection with a distribution of securities offered for cash (''offered securities'') 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 the pricing; or

(2) The period beginning with such filing 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 will not be 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 to any transaction or transactions, either unconditionally or on specified terms and conditions.

Dated: April 11, 1996.

By the Commission.

Margaret H. McFarland,

*Deputy Secretary.*

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