Diploma in Capital Markets, Regulation and Compliance

Short Course: Introduction to US Regulation

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Diploma in Capital Markets, Regulation and Compliance

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DIPLOMA IN CAPITAL MARKETS, REGULATION AND COMPLIANCE

By: William Jannace, Michael Troha and Anita Moore

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DIPLOMA IN CAPITAL MARKETS, REGULATION AND COMPLIANCE

By: William Jannace, Michael Troha and Anita Moore[1]

I. THE FEDERAL SECURITIES LAWS

A. The Securities Act of 1933[2] ("the Securities Act")

1. Passed in response to the stock market crash of 1929 and the ensuing Great Depression, it was the first major federal legislation to regulate the offer and sale of securities.
2. The Securities Act focuses on the primary market, where securities are first issued.
3. The Securities Act established the requirement that any offer or sale of securities within interstate commerce be registered with the SEC, unless an exemption exists under the Act.
4. It mandates disclosure of material information through a prospectus regarding the security being offered.
5. It prohibits deceit, misrepresentations, and fraud in the sale of securities.
6. Failure to register securities pursuant to the Securities Act carries criminal penalties, administrative sanctions, and civil liability.

B. The Securities Exchange Act of 1934[3] ("the Exchange Act")

1. The Exchange Act focuses on the secondary market, including exchanges, and forms the basis of financial market regulation in the United States today.
2. It created the SEC, with broad powers to enforce the federal securities laws.[4]
3. It requires stock exchanges to be self-regulatory organizations ("SROs").[5]

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[1] William Jannace is the Managing Director of Sales Practice Policy at FINRA. Michael Troha is a Senior Staff Attorney and Anita Moore is a Rule Interpretive Associate, both in Sales Practice Policy. Additionally, the authors wish to thank interns Lindsay Anastasi and David Szalyga for their contributions.

[2] 15 U.S.C. § 77a *et seq* (2008).

[3] 15 U.S.C. § 78a *et seq* (2008).

[4] 15 U.S.C. § 78d.

[5] 15 U.S.C. § 78f.

4. It initiated national regulation of the securities industry,[6] namely, the stock exchanges[7] and securities firms.[8]
5. It prohibits manipulative stock market practices.[9]
6. It regulates insider trading in public companies.[10]
7. It makes it unlawful for any broker dealer to effect any transaction in a security on a national exchange unless registered with the SEC.[11] Being registered with the SEC triggers periodic reporting requirements.
    a) These periodic reports include the 10-K annual report and the 10-Q quarterly report.
    b) Also required is a Form 8-K detailing material changes in the issuer's condition or operations.[12]

C. The Maloney Act of 1938[13]

1. The act is an amendment to the Exchange Act which permits self-regulation within the securities industry, specifically regulation of over-the-counter securities markets by national associations registered with the SEC, such as the SRO FINRA.[14]

D. The Investment Company Act of 1940[15]

1. It regulates mutual funds and other investment companies
2. It requires that investment companies register with the SEC and have boards composed of a majority of independent directors.
3. The SEC oversees the operations of investment companies, which are subject to modified registration and prospectus delivery rules when they issue securities.

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[6] States began to individually pass securities regulation applicable only to their state beginning in 1911. These state securities laws are called "Blue Sky" laws.

[7] 15 U.S.C. § 78f.

[8] 15 U.S.C. § 78o.

[9] 15 U.S.C. §§ 78i – j.

[10] 15 U.S.C. § 78p.

[11] *See* 15 U.S.C. § 78l. These registration requirements cease when the registered securities have fewer than three hundred shareholders of record or when there are fewer than five hundred shareholders on the last day of each of the past three years. *See* 15 U.S.C. § 78o(d).

[12] *See* 15 U.S.C. § 78m.

[13] Pub. L. 719, 52 Stat. 1070 (codified as amended at 15 U.S.C. § 15(a)).

[14] FINRA, created in July 2007, is the consolidation of the NASD and the regulation, enforcement, and arbitration functions of the New York Stock Exchange. *See* About the Financial Industry Regulatory Authority, FINRA, http://www.finra.org/AboutFINRA/index.htm.

[15] 15 U.S.C. § 80a-1 *et seq* (2008).

4. The act also authorizes the SEC, in conjunction with FINRA, to regulate advisory fees and other charges levied by fund advisers.
5. Additionally, the act seeks to minimize conflicts of interest and prevent abuses through disclosure of each investment company's structure, operations, financial condition, and investment policies when shares of the investment company are initially offered to the public and, thereafter, on a regular periodic bases.

E. The Investment Advisers Act of 1940[16]

1. The act requires the registration of anyone in the business of offering investment advice for a fee.
2. It requires investment advisers to disclose their interests in transactions executed for their clients and prohibits fraud.

F. Securities Acts Amendments of 1975[17]

1. The amendments contained directives that the SEC work with the industry to create a national market system.
2. They abolished fixed commissions charged by brokerage houses, and instead provided that brokerages were free to charge whatever fees they determine are acceptable.
3. The amendments also gave the SEC the final decision in the adoption of rules by any SROs.

G. The Securities Investor Protection Act[18] ("SIPA")

1. SIPA established an independent non-profit corporation, the Securities Investors Protection Corporation ("SIPC"), which provided that SIPC could assess all registered broker dealers and create a fund which would pay money to customer for claims when the brokerage firm had insufficient assets to meet its customer obligations.
2. SIPC does not cover individuals who are sold worthless stocks and other securities. SIPC helps individuals whose money, stocks, and other securities are stolen by a broker or put at risk when a brokerage fails for other reasons.

H. The Sarbanes-Oxley Act[19]

1. It regulates accounting firms and was designed to ensure that audits are independent and objective.

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[16] 15 U.S.C. § 80b-1 *et seq* (2008).

[17] Pub. L. 94-29 (codified as amended at 15 U.S.C. § 78a *et seq.*).

[18] Pub. L. 91-598, 84 Stat. 1636 (codified as amended at 15 U.S.C. § 78aaa *et seq.*).

[19] Pub. L. 107-204, 116 Stat. 745.

2. It requires that annual and quarterly financial reports must disclose all material off-balance sheet transactions and other relationships with off-balance sheet entities.

II. REGISTRATION OF SELF-REGULATORY ORGANIZATIONS

A. Overview

1. Sections 5,[20] 6,[21] and 15A[22] of the Exchange Act require national securities exchanges and national securities associations to be registered with the SEC. The SEC, however, may exempt from registration exchanges and broker dealers under certain circumstances.[23]

2. SEC regulation of the securities industry is supplemented by a system of self-regulation.

3. Under Sections 6(b) and 15A of the Exchange Act, an exchange and a securities association cannot be registered unless the SEC determines that its rules are designed, among other things, to "prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade,"[24] and to provide for appropriate discipline of its members for any violation of its own rules or the securities laws.[25]

4. Under this authority, exchanges and securities associations have maintained, enforced, and amended when necessary, a large body of rules for the conduct of their members. Rules fall into two categories:

a) Rules relating to transactions on a particular exchange and/or market; and

b) Rules relating to the internal operations of the member firms, their personnel, and their dealings with their customers.

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[20] 15 U.S.C. § 78e.

[21] 15 U.S.C. § 78f.

[22] 15 U.S.C. § 78o-3.

[23] *See* Exchange Act § 5, 15 U.S.C. § 78e (stating that an exchange can be exempted from registration if "in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration"; Exchange Act § 15, 15 U.S.C. § 78o(a)(2) ("The Commission, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from . . . [registration] any broker or dealer or class of brokers or dealers specified in such rule or order.").

[24] 15 U.S.C. § 78f(b)(5).

[25] *See* 15 U.S.C. § 78o-3(2)(C).

5. The first group of rules governs the criteria for listing securities on the exchange and marketplace, and provisions for delisting or suspension of trading in particular securities. These include:

   a) Obligations of issuers of listed securities;

   b) Activities of “specialists” and market makers;

   c) Conditions under which transactions in listed and OTC securities may be effected; and

   d) Rules for the governance and operation of the exchange and association.

6. In the second group are rules governing:

   a) The form or organization of member firms and qualifications of their associated person;

   b) Net Capital and Customer Protection Rules;

      (1) Rule 15c3-1[26] – Net Capital

      (2) Rule 15c3-3[27] – Customer Protection Rule

   c) Books and records of broker dealers;

      (1) Rules 17a-3[28] and 17a-4[29]/NYSE Rule 440/NASD Rule 3110[30]

   d) Financial statements and reports; and

      (1) Rule 17a-5[31]

      (2) FOCUS Filing[32]

   e) broker dealer notification provisions.

      (1) Rule 17a-11[33] requires a broker dealer whose net capital is at any time less than its requirement to notify the SEC and the firm’s SRO.

B. SEC/SRO Interaction and Oversight

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[26] 17 C.F.R. § 240.15c3-1 (2008).

[27] 17 C.F.R. § 240.15c3-3.

[28] 17 C.F.R. § 240.17a-3.

[29] 17 C.F.R. § 240.17a-4.

[30] FINRA recently proposed a consolidated FINRA Rule to govern books and records requirements which would replace those requirements under NASD Rule 3110(a) and NYSE Rule 440. *See* FINRA, Regulatory Notice 08-25: Books and Records (May 2008).

[31] 17 C.F.R. § 240.17a-5.

[32] A FOCUS (Financial and Operational Combined Uniform Single Report) filing is required to give a complete, detailed picture of member firms' financial and operational conditions. The filing is required by Rule 17a-5 (17 C.F.R. § 240.17a-5).

[33] 17 C.F.R. § 240.17a-11.

1. Under the U.S system, broker dealers are subject to direct regulation by the SEC as well as by the SROs of which they are members. The SEC also regulates broker dealers indirectly through its oversight of the regulatory activities of the SROs.

2. The SROs, in turn, require their members to adopt rules and enforce supervisory policies and procedures.

3. Because the Exchange Act does not give the SEC general authority to adopt rules governing the conduct of broker dealers in relation to their customers, the SEC relies on the SROs to regulate this aspect of the securities market. The SROs, while maintaining enforcement and examination staffs of their own, rely on the firms' compliance procedures to enforce their rules.

4. Rule 19g2-1[34] under the Exchange Act requires SROs to enforce SEC and SRO rules, subject to oversight by the SEC's Office of Compliance Inspections and Examinations ("OCIE").

C. Enforcement

1. An SRO brings actions for violation of SRO and/or SEC Rules.

2. Disciplinary actions can cover both underlying predicate violations as well as violations relating to a failure to supervise.

3. SROs do not have subpoena power, however they can compel cooperation.

4. Standards of Supervision

a) With the exception of violations arising from Section 15(f)[35] of the Exchange Act, the SEC requires a predicate violation in order to allege a failure to supervise.

b) In contrast, an SRO's Supervision Rules do not require a predicate violation.

5. Investigations can result from member firm reporting obligations, e.g., Form U5, RE-3 and examination findings.[36]

6. Disciplinary action can result in censures, monetary fines, suspensions and undertakings.

D. The SRO Rule-Making Process

1. As a registered securities exchange and registered securities association, the NYSE and FINRA are subject to the regulatory oversight of the SEC. Accordingly, all rules and rule amendments proposed by the NYSE and FINRA must be submitted to the SEC

[34] 17 C.F.R. § 240.19g-2.

[35] 15 U.S.C. § 78o(f).

[36] *See* NYSE Rule 351; NASD Rule 3070.

via a 19b-4 filing.[37] A 19b-4 filing contains the proposed rule text, its intended purpose, and its statutory basis.[38]

2. Once a proposed rule change is filed with the SEC, the substance of the change is published in the Federal Register for a prescribed period of time, giving interested parties the opportunity to comment on it. Comment letters are forwarded to the NYSE and FINRA for response. If necessary, and when appropriate, the NYSE and FINRA will amend the original filing in response to comment letters and resubmit the amended filing to the SEC.

3. Ultimately, when the SEC approves a proposed rule change, it will issue an "Approval Order" for publication in the Federal Register. Shortly thereafter, the NYSE will typically issue a corresponding Information Memo and FINRA will issue a Regulatory Notice, alerting their memberships to the rule change, its history, and its effective date.

E. FINRA (formerly NASD)

1. The NASD has traditionally been the primary self-regulator of broker dealers who are not members of a national securities exchange. Accordingly, most broker dealers are, and are required to be, members of FINRA.

2. FINRA promulgates Rules of Conduct that govern the activities of its members. It also reviews members' advertising practices, administers licensing exams for securities principals and registered representatives, and arbitrates disputes between members and employees or customers.

3. Merger of NASD and NYSE: FINRA

a) In 2007, following the merger of the NASD and NYSE, FINRA established rules that consisted of the NASD Rules and certain incorporated NYSE Rules.[39]

b) Existing NASD member firms as of July 30, 2007, remained subject to the NASD Rules in effect, and will become subject to FINRA Rules as they are adopted.

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[37] 17 C.F.R. § 240.19b-4.

[38] On July 11, 2008, the SEC approved guidance regarding proposed rule changes that are submitted by SROs in an effort to streamline the process by which SROs file proposed rule changes with the SEC and result in a broader range of rule changes qualifying for immediate effectiveness. *See* Commission Guidance and Amendment to the Rules Relating to Organization and Program Management Concerning Proposed Rule Changes Filed by Self-Regulatory Organizations, Exchange Act Release No. 58092 (July 11, 2008).

[39] *See* Order Approving Amendment to the By-Laws of NASD to Implement Changes to Accommodate the Consolidation of NASD and NYSE Regulation, Exchange Act Release No. 56145 (July 26, 2007).

c) Existing NYSE member firms as of July 30, 2007, remained subject to the incorporated NYSE Rules, and will become subject to FINRA Rules as they are adopted.

d) "Dual Members" of NASD and NYSE remain subject to both the NASD and NYSE Rules as applicable, and will become subject to FINRA Rules as they are adopted.

e) All FINRA members became subject to the FINRA By-Laws.

III. REGISTRATION PROCESS FOR BROKER DEALERS

A. A broker dealer generally cannot register with the SEC without becoming a member of FINRA.

B. Registered broker dealers without U.S. offices are subject to certain requirements primarily intended to facilitate regulatory inspections.[40]

C. A securities firm must become a member of an exchange in order to execute transactions in listed securities on an exchange.

IV. FINRA MEMBERSHIP PROCESS

A. The Application (NASD Rule 1013)[41]

1. Beginning June 26, 2008, when an Applicant for FINRA membership files an application, it includes an electronic component filed through the Firm Gateway, and a hard copy component sent to the Department of Member Regulation.[42].

2. An Applicant must submit the following in hard-copy form:

a) Any appropriate Entitlement Forms;

b) Form BD[43];

c) Member Firm Email Notification Contract Form; and

d) The Member Assessment Report.

3. An Applicant must submit the following electronically:

a) Forms U4 for all proposed associated persons;

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[40] *See* Exchange Act Rule 17a-7 (17 C.F.R. § 240.17a-7) (maintenance of records of foreign broker dealers); *see also* NASD Rule 1090.

[41] NASD Rule 1013.

[42] *See* FINRA, Regulatory Notice 08-14: New Member Application (Mar. 2008) *available at* http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p038196.pdf.

[43] As explained in the Instructions to Form BD, "Form BD is the Uniform Application for broker dealer Registration. broker dealers must file this form to register with the Securities and Exchange Commission, the self-regulatory organizations, and jurisdictions through the Central Registration Depository ("CRD") system, operated by FINRA." Form BD, SEC, http://www.sec.gov/about/forms/formbd.pdf at page 2 (emphasis omitted).

b) Forms BR for each proposed location;

c) An Amended Form BD, as appropriate; and

d) Form NMA.

B. The Applicant's Employees

1. The employees of the Applicant who will be participating in the new broker dealer's business must be properly registered with FINRA, and with any other applicable SROs or state regulatory authorities.

2. FINRA generally requires at least two registered Supervisory Principals who have passed the Series 24 exam, and a Financial and Operations and Operations Principal who has passed the Series 27 exam. In certain circumstances FINRA many grant a wavier of the certain Supervisory Principal requirements.

C. The Membership Interview

1. Before being granted membership in FINRA, an Applicant broker dealer must have a membership interview.[44]

2. The interview will generally focus on the following:

a) Record keeping procedures;

b) Compliance procedures; and

c) Familiarity with the U.S. securities laws and FINRA rules.

D. Department Decision – Standards for Admission (NASD Rule 1014)[45]

1. After considering the application, the membership interview, other information and documents, and public interest and protection of investors, FINRA's Membership Department determines whether an Applicant meets each of the specific standards.

2. The Membership Department may grant the application subject to restrictions, and explain the reason for each restriction in terms of specific standards for the membership.

3. The Membership Department issues a written decision on the application within 30 days of the conclusion of the interview or the submission of additional information, whichever is later.

E. The Membership Agreement

1. At the time a new broker dealer is approved for membership by FINRA, FINRA will send the new member a "Member Agreement" that describes the type of business the new member is permitted to conduct.

F. The Initial Inspection

[44] NASD Rule 1013(b).

[45] NASD Rule 1014(a).

1. The primary examining SRO for a newly-registered broker dealer is required to conduct:

a) An inspection to determine compliance with the SEC's financial responsibility rules within six months of the firm's registration;[46] and

b) A general inspection within twelve months of registration.

2. No advance notice need be given of such inspections.

V. REGISTRATION OF BROKER DEALERS

A. Firms can act in any of the following three capacities in the securities industry:

1. Brokers;
2. Dealers; and
3. Investment advisers.

B. Section 3(a)(4)[47] of the Exchange Act defines a "Broker" as a person engaged in the business of effecting transactions for the accounts of others.

C. Section 3(a)(5)[48] of the Exchange Act defines a "Dealer" as a person engaged in the business of buying and selling securities for his own account.

D. Under Section 15(a)[49] of the Exchange Act, no person may engage in business as a broker or dealer in securities without being registered with the SEC (unless he does exclusively intrastate business or deals only in exempted securities). Exempted securities include:

1. Commercial paper;
2. Bankers' acceptances; and
3. Commercial bills.

E. Unless exempted by the SEC, every broker dealer is required pursuant to Section 15(b)(8)[50] of the Exchange Act to be a member of FINRA to transact business effectively in the OTC market.[51]

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[46] *See* Exchange Act Rule 15b2-2 (17 C.F.R. § 240.15b2-2).

[47] 15 U.S.C. § 78c(a)(4).

[48] 15 U.S.C. § 78c(a)(5).

[49] 15 U.S.C. § 78o(a).

[50] 15 U.S.C. § 78o(b)(8).

[51] 15 U.S.C. § 78o(b)(8). *See also* Exchange Act § 15A(e) (15 U.S.C. § 78o-3(e)); NASD Rule 2440; Exchange Act Rule 15b9-1 (17 C.F.R. § 240.15b9-1); Exchange Act Rule 15b9-2 (17 C.F.R. § 240.15b9-2).

1. Section 15A(e)(1) of the Exchange Act allows SROs to create rules which prohibit members from dealing with nonmember professionals "except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public."[52]

2. Section 15A(e)(2) states that "nonmember professionals" shall include "with respect to transactions in securities other than municipal securities, any registered broker or dealer who is not a member of any registered securities association, except such a broker or dealer who deals exclusively in commercial paper, banker's acceptances, and commercial bills, and . . . with respect to transactions in municipal securities, any municipal securities dealer (other than a bank or division or department of a bank) who is not a member of any registered securities association and any municipal securities broker who is not a member of any such association."[53]

3. NASD Rule 2440 provides that when a member buys for his own account from his customer or sells from his own account to his customer, the buy/sell price must be:

a) Fair, taking into consideration circumstances such as market conditions and the fact that the member is entitled to a profit; and

b) If the member acts as agent for his customer, must not include more than a fair commission or service charge, taking into account market conditions, the expense of executing the order, and the member's level of knowledge and experience.

F. Broker dealers of government securities (exempted securities) are not required to register under Section 15(b) of the Exchange Act but must register as government securities broker dealers under Section 15C[54] of the Exchange Act.

G. State blue-sky laws require registration of broker dealers and their employees who do business within a particular state or with customers present in that state. The National Securities Market Improvements Act of 1996[55] prohibits states from adopting their own regulations governing broker dealer net capital and recordkeeping requirements.

H. Registration of Associated Persons

[52] 15 U.S.C. § 78o-3(e)(1).

[53] 15 U.S.C. § 78o-3(e)(2).

[54] 15 U.S.C. § 78o-5.

[55] National Securities Markets Improvement Act, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended in various sections of 15 U.S.C.).

1. Section 15 of the Exchange Act[56] provides a registration exemption for any natural person who is an “associated person” of a broker dealer registered with the SEC.

2. The “natural person” exemption is premised on such person being appropriately registered and qualified by an SRO as an “associated person” of a member organization.

3. Section 15(b)(7)[57] of the Exchange Act gives the SEC authority to set “standards of training, experience, competence, and such other qualifications” as the SEC deems necessary for “associated persons” of a broker dealer.[58]

4. Under Section 15(b), the SEC may revoke or suspend a broker dealer’s registration, or impose a censure, if the broker dealer is found to have violated any of the federal securities laws or committed other specified misdeeds.

5. FINRA may deny membership to any broker dealer that does not meet its standards of “financial responsibility or operational capacity,”[59] or if the broker dealer or its associated persons have engaged in, and are reasonably likely to engage in again, “acts or practices inconsistent with just and equitable principles of trade.”[60]

6. Rule 15b7-1[61] under the Exchange Act permits the SEC to impose fines of up to $100,000 on a broker dealer for each of its associated persons that is not appropriately qualified with an SRO.

7. The term “associated person” is defined in the Exchange Act in the following ways:

a) Section 3(a)(21)[62] provides that the term “person associated with a member” or “associated person of a member,” when used with respect to a member of a national securities exchange or registered securities association means any partner, officer, director, or branch manager of such member (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such member, or any employee of such member.

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[56] 15 U.S.C. § 78o(a)(1).

[57] 15 U.S.C. § 78o(b)(7).

[58] 15 U.S.C. § 78a(b)(7)(A).

[59] 15 U.S.C. § 78o-3(g)(3)(A).

[60] 15 U.S.C. § 78o-3(g)(3)(A). *See* Exchange Act § 15A(g)(4) (15 U.S.C. § 78o-3(g)(4)).

[61] 17 C.F.R. § 240.15b7-1.

[62] 15 U.S.C. § 78c(a)(21).

b) Section 3(a)(9)[63] provides that the term “person” means a natural person, company, government, or political subdivision, agency, or instrumentality of a government.

8. Section 15(b)(6)[64] provides the SEC with authority to censure, place limitations on the activities or functions of a person associated with a member, or suspend for a period not exceeding 12 months, or bar such person from being associated with a broker or dealer, or from participating in an offering of penny stock.

9. FINRA Article (rr) of the FINRA By-Laws defines “person associated with a member” or “associated person of a member” to mean:

a) A natural person who is registered or has applied for registration under Rules of the Association;

b) A sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with FINRA under these By-Laws or the Rules of the Association; and

c) Any other person listed in Schedule A of Form BD of a member for purposes of Rule 8210.

10. NASD Rule 1011(b) defines “Associated Person” to mean:

a) A natural person registered under NASD Rules; or

b) A sole proprietor, or any partner, officer, director, branch manager of the Applicant, or any person occupying a similar status or performing similar functions;

c) Any company, government or political subdivision or agency or instrumentality of a government controlled by or controlling the Applicant;

d) Any employee of the Applicant, except any person whose functions are solely clerical or ministerial;

e) Any person directly or indirectly controlling the Applicant whether or not such person is registered or exempt from registration under FINRA By-Laws or FINRA Rules;

f) Any person engaged in investment banking or securities business controlled directly or indirectly by the Applicant

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[63] 15 U.S.C. § 78c(a)(9).

[64] 15 U.S.C. § 78o(b)(6).

whether such person is registered or exempt from registration under FINRA By-Laws or FINRA Rules; or

g) Any person who will be or is anticipated to be a person described in (a) through (g) above.

11. Section 6(c)(3)(B)[65] of the Exchange Act permits an exchange to bar a natural person from becoming associated with a member, or condition the membership of a natural person or association of a natural person with a member, if such natural person (1) does not meet such standards of training, experience, and competence as are prescribed by the rules of the exchange or (2) has engaged and there is a reasonable likelihood he may again engage in acts or practices inconsistent with just and equitable principles of trade.

12. Section 15A(g)(3)[66] permits FINRA to bar a natural person from becoming associated with an FINRA member if it fails to meet FINRA's standards of training, experience and competence.

13. NASD Rule 1031 requires that "[a]ll persons engaged or to be engaged in the investment banking or securities business of a member who are to function as representatives shall be registered as such with FINRA in the category of registration appropriate to the function to be performed."

14. Before their registration can become effective, the person must pass an appropriate qualification examination.

15. A person whose registration is terminated for two years or more is required to retake the Series 7 or other appropriate qualification exam.

16. Rule 1031 specifically states that a firm shall not maintain a representative's registration with FINRA if the person:

a) Is no longer active in the member's investment banking or securities business;

b) Is no longer functioning as a representative; or

c) Has the sole intention of avoiding the examination requirements associated with registration.

17. Rule 1031 also permits, but does not require, member firms to maintain or make application for persons who:

a) Perform legal responsibilities;

b) Perform compliance responsibilities;

c) Perform internal audit responsibilities;

d) Perform back-office operations;

[65] 15 U.S.C. § 78f(c)(3)(B).

[66] 15 U.S.C. § 78o-3.

e) Perform similar responsibilities for the member;

f) Perform administrative support functions for registered personnel; or

g) Are engaged in the investment banking or securities business of a foreign securities affiliate or subsidiary of the member.

18. If a permissively registered person no longer performs any of the foregoing functions, then the member firm must promptly terminate such person.

19. Additionally, NYSE Rule 345 sets forth the registration, approval and records requirements for employees of member organizations.

VI. EXEMPTIONS FOR FOREIGN BROKER DEALERS

A. Scope of Rule 15a-6[67] under the Exchange Act

1. Rule 15a-6 provides conditional exemptions from U.S. registration for foreign broker dealers that engage in certain direct and indirect activities involving U.S. investors and securities markets, including providing research to U.S. persons.[68]

2. Exemptions generally apply to transactions with an "institutional investor," which includes registered investment advisers, banks, saving and loan, insurance companies, business development companies, small business investment companies, employee benefit plans and certain other organizations.

3. In some cases, exemptions are limited to transactions with a "major U.S. institutional investor," which is an institutional investor that has at least $100 million in total assets or total assets under management.

4. Proposed Amendment to Scope of Rule 15a-6

a) On June 25, 2008, the SEC proposed amending Rule 15a-6 to exempt from all Exchange Act requirements (other than antifraud rules) for foreign broker dealers that engage in certain limited activities in the U.S.[69]

b) The exemption under the proposed amended Rule 15a-6 would generally apply to transactions with a "qualified

[67] 17 C.F.R. § 240.15a-6.

[68] The SEC is proposing to amend Rule 15a-6 to increase the range of services foreign broker dealers are allowed to offer in the United States. *See* Exemption of Certain Foreign Brokers or Dealers, Exchange Act Release No.58047 (June 27, 2008).

[69] *See* Exemption of Certain Foreign Brokers or Dealers, Exchange Act Release No.58047 (June 27, 2008).

investor," which generally includes the same entities that fall under the U.S. institutional investor definition, plus broker dealers, foreign banks, foreign governments, multi-national entities or agencies and most hedge funds (regardless of asset size), plus entities or natural persons with $25 million or more in investments, and state and local government agencies with $50 million or more in investments.

B. Unsolicited Trades under Rule 15a-6

1. Rule 15a-6 permits foreign broker dealers to execute unsolicited trades with any U.S. person.

2. Proposed Amendment to Rule 15a-6

a) Unsolicited trades are still exempt, but the definition of unsolicited would be expanded to allow U.S. third party quotation systems to carry foreign broker dealers' quotes.

C. Provision of Research Reports under Rule 15a-6:

1. Rule 15a-6 permits foreign broker dealers to furnish research reports to, and execute transactions in the securities discussed in the research reports for, major institutional investors, provided that:

a) The research reports do not recommend the use of the foreign broker dealer to execute the transaction;

b) The foreign broker dealer does not initiate contact with the major institutional investors to follow up on the research reports, and does not otherwise induce or attempt to induce transactions with investors;

c) If the foreign broker dealer has a relationship with a U.S. broker dealer that allows it to solicit trades, any transactions in securities discussed in the research report are made through the U.S. broker dealer; and

d) The foreign broker dealer does not enter any soft dollar arrangements with U.S. investors.

2. Proposed Amendment to Rule 15a-6

a) The proposed rule would permit foreign broker dealers to furnish research reports to, and execute transactions for qualified investors rather than major institutional investors.

D. Solicited Trades under Rule 15a-6:

1. Rule 15a-6 permits broker dealers to solicit trades from institutional investors and major institutional investors provided that:

a) The foreign broker dealer effects trades through a U.S. broker dealer;

b) The foreign broker dealer provides information to the SEC as requested, unless prohibited by foreign law;

c) The foreign broker dealer's employees conduct all business from outside the U.S., except for certain visits to the U.S. where the foreign broker dealer's employees are chaperoned by a U.S. broker dealer employee (subject to limited exceptions for visits with major institutional investors);

d) During any visits, the U.S. broker dealer takes responsibility for communications made in the U.S. to all institutional investors, including major institutional investors;

e) The U.S. broker dealer chaperones all oral communications with institutional investors other than major institutional investors (subject to limited exceptions);

f) The U.S. broker dealer determines that the foreign broker dealer's employees are not subject to statutory disqualification or its foreign equivalent;

g) The U.S. broker dealer is responsible for effecting transactions, sending out confirmations and statements, extending and arranging for margin credit, maintaining books and records, complying with applicable net capital requirements, and maintaining custody of securities;

h) The U.S. broker dealer obtains certain records from the foreign broker dealer regarding its employees doing business in the U.S.;

i) The foreign broker dealer consents to service of process of any civil action by serving the broker dealer; and

j) The U.S. broker dealer maintains records of all of the above in a U.S. office, and makes these records available to the SEC upon request.

2. Proposed Amendment to Rule 15a-6

a) The proposed rule would permit foreign broker dealers to solicit trades from qualified investors (rather than institutional investors or major institutional investors), subject to some of the same conditions that currently apply. However, the solicited trades provisions would change significantly.

b) The proposal would eliminate the requirements to have a U.S. broker dealer chaperone contacts with U.S. investors. In addition, foreign broker dealer employee "visits" to the U.S. could be up to 180 days per year in the aggregate, per employee.

c) The proposal would add a requirement to disclose that the foreign broker dealer is regulated by a foreign securities authority and not the SEC.

d) The proposal would create two alternatives for executing solicited trades, which are known as Exemption (A)(1) and Exemption (A)(2).

e) Exemption (A)(1)

(1) This exemption is only available for foreign broker dealers that conduct a "foreign business," which means that at least 85% of the foreign broker dealer's business with U.S. qualified investors and foreign resident clients is derived from transactions in foreign securities.

(2) The foreign broker dealer could effect transactions in foreign securities directly with qualified investors and maintain custody of clients' assets rather than using a U.S. broker dealer.

(3) The U.S. broker dealer would no longer have to maintain accounts for the foreign broker dealer, extend or arrange for margin credit, issue confirms or account statements, follow SRO Rules, or comply with money laundering laws for U.S. client transactions.

(4) However, a U.S. broker dealer would either have to maintain records of the foreign broker dealer's solicited transactions with U.S. clients, or be able to obtain them promptly from the foreign broker dealer.

(5) As a practical matter, the U.S. broker dealer would have toe execute most solicited transactions in U.S. securities for the foreign broker dealer, and the execution would be subject to U.S. securities laws and SRO rules.

(6) The foreign broker dealer would have to disclose that U.S. asset segregation requirements, bankruptcy protections, and SIPC protections do not apply to the foreign broker dealer accounts.

f) Exemption (A)(2)

(1) Under this exemption, the U.S. broker dealer would have to carry customer accounts and custody client assets, rather than the foreign broker dealer.

(2) However, unlike the current rule, the U.S. broker dealer would not have to effect client transactions in

foreign securities, thus relieving the U.S. broker dealer from having to comply with most U.S. securities laws and all SRO rules.

(3) Like exemption (A)(1), as a practical matter, the U.S. broker dealer would have to effect transactions in most U.S. securities, and the execution of those transactions would be subject to U.S. securities laws and SRO rules.

E. Counterparties and Specific Customers under Rule 15a-6

1. Rule 15a-6 permits foreign broker dealers to effect solicited and unsolicited trades with:

a) Registered U.S. broker dealers;

b) U.S. banks;

c) Certain international development banks;

d) Foreign persons temporarily present in the U.S. with whom the foreign broker dealer has a pore-existing relationship;

e) Agencies or branches of U.S. persons permanently located outside the U.S., provided the transaction is offshore; and

f) U.S. citizens resident outside the U.S., provided that the transaction is offshore and the foreign broker dealer does not direct its selling efforts toward unidentifiable groups of U.S. citizens.

2. Proposed Amendments to Rule 15a-6

a) Same exemptions as current rule, plus an additional exemption for transactions with U.S. resident fiduciaries of accounts for foreign resident clients. This additional category is already permitted under a 1996 SEC no-action letter.

F. Foreign Options Exchanges

1. Rule 15a-6 currently does not provide an exemption, but SEC no-action letter permits foreign option exchanges to familiarize U.S. investors with options traded on foreign exchanges.

2. Proposed Amendments to Rule 15a-6

a) Codifies no-action relief.

VII. MARKET STRUCTURE AND TRADING

DD. Overview

1. National Market System

2. Stock Exchanges
    a) American Stock Exchange (“AMEX”)[70]
    b) Chicago Board Options Exchange (“CBOE”)
    c) Chicago Stock Exchange (“CHX”)
    d) International Securities Exchange (“ISE”)
    e) Nasdaq Stock Market, LLC (“Nasdaq”)[71]
        (1) Boston Stock Exchange (“BSE”)
        (2) Philadelphia Stock Exchange (“PHLX”)
    f) National Stock Exchange (“NSX”)
    g) New York Stock Exchange (“NYSE”)
        (1) NYSE MatchPoint – Portfolio-based, point-in-time, electronic facility of NYSE that matches aggregated orders at predetermined sessions through regular hours and after hours of the Exchange.
            (a) MatchPoint trades securities listed on all major and regional exchanges.
        (2) NYSE-BIDS – A joint venture between the NYSE and BIDS Trading to provide access to dark pool networks which is expected to be available by the end of 2008.
    h) NYSE Arca (“Arca”)
3. OTP/UTP Plan
    a) The OTC/UTP Plan governs the collection, processing and distribution of all OTC/UTP data and is composed of the following market centers: American Stock Exchange, NYSE Arca, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, International Securities Exchange, Nasdaq Stock Market, FINRA, National Stock Exchange, New York Stock Exchange and Philadelphia Stock Exchange. The OTC/UTP Plan is administered by the participant exchanges and associations which determine policy matters and oversee system operations. Further,

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[70] *See* Notice of Proposed Rule Change for AMEX and Amendment No. 1 Relating to the Acquisition of the AMEX by the NYSE, Exchange Act Release No. 58282 (August 1, 2008).

[71] On July 17, 2008, the SEC approved rule changes to Nasdaq’s parent company, Nasdaq OMX, to finalize the acquisitions of BSE and PHLX by Nasdaq OMX. Following the acquisitions, Nasdaq would maintain its current registration as a national securities exchange, and would maintain rules, membership rosters, and listings that would be separate and distinct from the rules, membership rosters, and listings of BSE and PHLX. *See* Order Approving Amendment to the By-Laws of Nasdaq OMX Group, Inc. to Implement Changes in Connection with the Acquisitions of Boston Stock Exchange and Philadelphia Stock Exchange, Exchange Act Release No. 58183 (July 17, 2008).

NYSE Arca currently is responsible for chairing the OTC/UTP Plan Committee. The OTC/UTP Plan has been approved by the SEC. Amendments to the plan are filed with the Commission in accordance with Section 11A of the Securities Exchange Act of 1934.

b) The OTC/UTP data feeds consist of one network, Tape C, which is the single source of consolidated market data for Nasdaq-listed securities. The UTP Quote Data Feed (UQDF) provides continuous quotations from all market centers trading Nasdaq-listed securities. The UTP Trade Data Feed (UTDF) provides continuous last sale information from all market centers trading Nasdaq-listed securities.

4. One national securities association: FINRA.

5. Many of the exchanges listed above outsource their regulatory functions to FINRA through Regulatory Service Agreements, whereby FINRA processes applications for membership to a given exchange and, in some cases, handles surveillance, investigation, and enforcement of the exchange's rules.

6. Trading of securities occurs in trading centers that are not securities exchanges.

7. Broker dealers have their own trading desks and internalize orders. Alternative trading systems, called "electronic communications networks," provide order execution as well.

FINRA also operates the Alternative Display Facility ("ADF"). "The ADF provides FINRA members with a facility for the display of over-the-counter (OTC) quotations, the reporting of OTC trades, and the comparison of OTC trades."[72]

EE. New York Stock Exchange ("NYSE")

1. Specialists maintain a fair and orderly market for the securities in which they specialize.

2. Floor brokers effect agency trades for public customers and institutional investors.

3. Competitive traders:

a) Trade own accounts;

b) Provide a stabilizing function to the market; and

c) Are prohibited from acting as floor brokers.

4. Registered Competitive Market Makers are members who:

a) Trade for their own accounts;

b) Act in a quasi-specialist capacity; and

[72] Alternative Display Facilities (ADF), FINRA, http://www.finra.org/RegulatorySystems/ADF/index.htm.

c) Act like floor brokers (but not in the same security for which they acted as RCMMs during the same trade day).

FF. American Stock Exchange ("AMEX")[73]

1. Specialists in either options or equities are required to keep a fair and orderly market in their respective securities.

2. Floor Brokers can be either commissioned or independent brokers. They are members of the exchange who participate in trading on the floor of the exchange to get the best price for their customers.

3. Registered Traders in either options or equities are exchange members who provide an additional source of liquidity for securities traded on the exchange. They trade for their own account and enhance the specialists' role of providing price continuity and liquidity on both sides of the market.

GG. Options Markets

1. The Exchanges

a) American Stock Exchange ("AMEX")

b) Chicago Board Options Exchange ("CBOE")

c) Philadelphia Stock Exchange ("PHLX")[74]

d) NYSE-Arca ("Arca")

e) International Securities Exchange ("ISE")

f) Boston Options Exchange ("BOX")

2. Options Clearing Corporation ("OCC")

HH. OTC Classes of Securities

1. The OTC Bulletin Board ("OTCBB")

a) To publish quotes, market makers must comply with SEC rules.

b) No minimum listing standards exist.

c) Issues are not included on any exchange or Nasdaq.

d) Non-Nasdaq or OTCBB registration is required.

(1) File a form with FINRA.

(2) The filing is made 3 business days prior to entering quotes in the Pink Sheets or the OTCBB.

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[73] *See* Notice of Proposed Rule Change for AMEX and Amendment No. 1 Relating to the Acquisition of the AMEX by the NYSE, Exchange Act Release No. 58282 (August 1, 2008).

[74] *See* Order Approving Amendment to the By-Laws of Nasdaq OMX Group, Inc. to Implement Changes in Connection with the Acquisitions of Boston Stock Exchange and Philadelphia Stock Exchange, Exchange Act Release No. 58183 (July 17, 2008).

2. The Pink Sheets

a) They list non-Nasdaq securities.

b) They are not a Nasdaq system, so are regulated by FINRA.

II. The Alternative Display Facility ("ADF")

1. Definition

a) An ADF is a display only Facility. It "does not provide automated order routing functionality, execution facilities, or linkages between ADF trading centers."[75]

b) It handles only activities in exchange-listed stocks.

c) ADF provides quoting and trade reporting and comparison.

d) ADF quotes are reached through private linkages.

2. FINRA built ADF as a condition to implementation of Nasdaq's SuperMontage System.

a) The SEC conditioned approval of SuperMontage on FINRA offering a quote trade reporting alternative that satisfies the Order Handling Rules, Regulation ATS, and other regulatory requirements for ATSs, ECNs, and market makers.[76]

3. ADF was launched on July 29, 2002.

a) FINRA satisfied its statutory obligations under Section 15A[77] of the Exchange Act and became an alternative for ECNs who were leaving Nasdaq.

b) ADF allows qualified members (ECNs to date) to quote, report trades, and compare trades.

c) ADF does note contain a FINRA-sponsored execution system – the market relies on private linkages.

d) The SEC requires FINRA to continue to provide ADF.[78]

e) ADF operates at a loss.

f) It does not rebate market data.

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[75] Alternative Display Facilities (ADF), FINRA, http://www.finra.org/RegulatorySystems/ADF/index.htm.

[76] *See* Press Release, SEC 2002-112, SEC Approves Pilot NASD Alternative Display Facility; Sets Meeting to Consider SuperMontage Conditions (July 25, 2002) *available at* www.sec.gov/news/press/2002-112.htm.

[77] 15 U.S.C. § 78o-3.

[78] *See* Press Release, SEC 2002-112, SEC Approves Pilot NASD Alternative Display Facility; Sets Meeting to Consider SuperMontage Conditions (July 25, 2002) *available at* www.sec.gov/news/press/2002-112.htm.

g) ADF's client base is entirely comprised of ECNs at this point in time.

(1) Instinet was the first ECN to post its quotes on ADF.

(2) Currently, Direct Edge and Lava Flow use ADF to post their quotes.

JJ. Trade Reporting Facilities

1. Definition

a) FINRA created Trade Reporting Facilities ("TRFs") as part of the registration of Nasdaq Stock Market LLC with the SEC.[79]

2. A TRF is a facilities agreement between the LLC and an exchange.

a) The agreement dictates the terms of technology operation and support.

b) FINRA acts as the counter-party, standing in for the LLC.

c) The TRFs operate under FINRA's SRO license.

d) The Exchange controls the business aspects, P&L, operations, and technology of the TRF.

e) FINRA conducts all regulation, including real time surveillance.

f) The TRFs are governed by 3 member board (2 from business member and 1 from FINRA).

3. The Exchange is responsible for:

a) Customer contact (only FINRA members);

b) Customer interface technology;

c) Reporting trades to the SIP (optional); and

d) Delivering trades to FINRA for audit trail simultaneous with the SIP.

4. FINRA is responsible for:

a) Real time market surveillance; and

b) Market regulation.

[79] *See* Press Release, SEC 2006-108, Commission Approves NASD Rule Changes Reflecting Nasdaq's Registration as a National Securities Exchange and Issues Order Modifying a Condition to Nasdaq's Operation as an Exchange (June 30, 2006) *available at*, http://www.sec.gov/news/press/2006/2006-108.htm.

5. TRFs allow OTC trading to still be subject to FINRA jurisdiction, but also allows exchanges to partner with FINRA to capture the economics of trades.

6. TRFs can only be created when FINRA has another separate system to meet its statutory obligation (e.g., the ADF).

7. TRF trades are not exchange trades.

8. FINRA is the "sole" regulator of TRFs.

9. TRFs do not quote.

10. TRFs participants will need to independently comply with NMS.

11. Current trade reporting facilities are:

    a) Nasdaq;[80]

        (1) Boston Stock Exchange ("BSE");

        (2) Philadelphia Stock Exchange ("PHLX")

    b) National Stock Exchange ("NSX"); and

    c) New York Stock Exchange ("NYSE"); and

12. TRFs are designed to handle trade prints for OTC trading in exchange listed stocks concerning:

    a) ECNs

    b) Internalized trades

13. TRFs are governed by FINRA rules.

    a) TRFs' and FINRA's boards must approve rules.

    b) Rules are drafted by FINRA based on the operational model established by the Exchange.

14. All TRFs are essentially the same.

    a) They are commodity businesses.

    b) Exchanges are offering other services to attract business as well as market data rebating.

KK. The registered clearing agencies are:

1. Depository Trust Company;

2. National Securities Clearing Corporation;

3. The Options Clearing Corporation; and

4. Omgeo.

    a) This clearing agency is not registered with the SEC.

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[80] *See* Order Approving Amendment to the By-Laws of Nasdaq OMX Group, Inc. to Implement Changes in Connection with the Acquisitions of Boston Stock Exchange and Philadelphia Stock Exchange, Exchange Act Release No. 58183 (July 17, 2008).

LL. The Municipal Securities Rule Making Board is the primary self-regulator for dealers in municipal securities.

1. It can engage in rulemaking, but has no enforcement capability.

MM. Market Maker Registration

1. Registration requirements for Nasdaq market makers

    a) Market makers must file an application with and be approved by FINRA.

    b) Application/registration for each security is required.

    c) Net capital requirements exist.

2. Market-making requirements

    a) Market makers must maintain a two-sided market.

    b) All quotes must be firm quotes. There are violation for backing away.

    c) Initial quotes must be entered within five business days of FINRA approval.

3. Market Maker Withdrawal of Quotes

    a) Excused withdrawals (up to 5 business days)

        (1) The market maker must apply to and receive permission from NASDAQ to withdraw its quotes.

        (2) Reasons for withdrawal include:

            (a) Personal equipment issues;

            (b) Vacation, religious holidays, or illness;

            (c) Acting as a passive market maker; and

            (d) Legal reasons, such as the market maker being in receipt of inside information, in which case a withdrawal of up to 60 days is allowed.

    b) A market maker’s quotes may be involuntarily withdrawn for failure to abide by rules.

    c) Voluntary Termination

        (1) The market maker may withdraw quotes from Nasdaq voluntarily by simply removing it.

        (2) The market maker cannot re-register as a market maker in that security for 20 business days after it removes the quote.

NN. Quotation Requirements

1. A market maker must maintain two-sided quotes (bid and ask) with a predefined spread.

2. The quotes must be continuous, with a buyer for every sell order and seller for every buy order at any time.

3. Market makers are required to honor their quotes. If they do not, they will be sanctioned.

OO. Order Routing and Execution Systems

1. Order Audit Trail System (“OATS”)

a) The system allows FINRA to reconstruct the entire life of an order, and thus surveil member firms to ensure proper execution of orders and to prevent violation of its rules.

b) The audit trail must provide an accurate, time-sequenced record of orders, beginning with receipt of order and further documenting the life of the order through execution or cancellation.

2. Members must synchronize business clocks used to indicate the date and time of any recordable event.

3. NYSE Rule

a) Front End Systematic Capture

PP. Automated Confirmation Transaction Service (“ACTS”)

1. Securities Reported

a) NNM

b) Bulletin Board

c) Third Market – listed executed OTC

d) Order size – Round and odd lots

2. Participation in ACT

a) Nasdaq member

b) ACT participation application

c) Clearing agency/clearing corporation

d) Participants

(1) Market makers

(2) Order entry firms

(3) Clearing broker

(4) Correspondent executing broker

(a) Give up arrangements

3. Attachment 2 agreements – locks firm in for ACT reporting purposes

a) Market maker reports – 90 seconds

b) Order entry firm has 20 minutes for acceptance/rejection – use browse function

4. Clearing broker responsibilities

a) Accept and clear

b) Correspondent executing broker

c) NYSE Rule 382

(1) Clearing agreements

5. Transactions exempt from ACT reporting requirements

6. Reporting responsibility

a) Transaction between two market makers – sell side reports

b) Transaction between market maker and nonmarket maker (order entry firm) – market maker reports

c) Transaction between two nonmarket makers – sell side reports

d) Transaction between member and customer – member reports.

QQ. The OTC Markets are:

1. The Nasdaq Stock Market;

2. The OTC Bulletin Board; and

3. The Pink Sheets.

RR. SEC Rule 15c2-11[81] - Initiation of Quotations for Non-Nasdaq OTC Securities

1. While broker dealers must formally register as Nasdaq market makers before entering quotes in that system, no such procedure is required for making a market in OTC securities that are not traded on Nasdaq. However, SEC Rule 15c2-11 requires that broker dealers who wish to publish quotes for a non-Nasdaq OTC equity must collect and review certain information about the issuer. For this rule, “publish” means to initiate or resume quotes in any interdealer quote medium, such as the OTCBB or the Pink Sheets.[82]

2. Information to Be Collected. Unless an exception is available, the broker dealer, prior to initiating or resuming quotes, must have in its possession one of the following five items related to the security in question:

[81] 17 C.F.R. § 240.15c2-11.

[82] 17 C.F.R. § 240.15c2-11.

a) A prospectus filed with the SEC under the Securities Act that has been in effect for less than 90 days;[83]

b) An offering circular, as specified in Regulation A,[84], effective within the preceding 40 days, containing:

(1) The par or stated value of the security;

(2) The number of shares or the total amount of the securities outstanding;

(3) The name and address of the transfer agent;

(4) The nature of the issuer's business;

(5) The nature of the products or services offered;

(6) The nature and extent of the issuer's facilities; and

(7) The nature of the Chief Executive Officer and members of the board of directors;.

c) The issuer's most recent annual report;

d) In the case of an issuer exempt from Section 12(g) of the Exchange Act, information furnished to the Commission pursuant to Rule 12g-2(b) under the Exchange Act[85] since the beginning of the issuer's last fiscal year; and.

e) Any additional information, which shall be reasonably current in relation to the day the quotation is submitted, which includes:

(1) Whether the broker or dealer or any associated person is affiliated, directly or indirectly, with the issuer;

(2) Whether the quote is being published or submitted on behalf of any other broker or dealer, and, if so, the name of such broker or dealer; and

(3) Whether the quote is being submitted or published, directly or indirectly, on behalf of the issuer, or any director, officer, or anyone who beneficially owns more than 10% of the outstanding shares or units of any equity of the issuer (if so, the name of the person and the basis for any exemption from federal securities laws for sales on behalf of the person must be disclosed).

[83] 17 C.F.R. § 240.15c2-11(a)(1).

[84] 17 C.F.R. §§ 230.251 – 300.

[85] 17 C.F.R. § 240.12g-2.

3. It is not enough for the dealer to simply have this information on file. The rule requires the dealer to review the information and have a reasonable basis for believing that:

a) The information is accurate in all material respects; and

b) The sources from which the information was obtained are reliable.

4. Information About the Quote. In addition to the preceding information, the dealer publishing the quote must have on file the following documents and information:

a) A record of the circumstances involved in the publication of the quote, including the identity of the person or persons for whom it is being published and any information regarding the transactions provided to the dealer by those persons;

b) A copy of any SEC trading suspension order for any security of the issuer during the preceding 12 months, or a copy of the SEC public release announcing the suspension; and

c) A copy or written record of any other material information (including adverse information) about the issuer that comes into the dealer's knowledge or possession before the publication of the quote.

5. The submission of information to FINRA.

a) The documentation compiled by a dealer under SEC Rule 15c2-11 must be submitted to FINRA, along with a completed Form 211,[86] at least three business days prior to entering a quote in a quotation medium. The filing should also specify:

(1) The issuer;

(2) The issuer's predecessor in the event of a merger or reorganization within the previous 12 months;

(3) The type of security to be quoted (e.g., ADR, warrant, unit, or common stock);

(4) The quotation medium to be used;

(5) The member's initial or resumed quote; and

(6) The particular subsection of Rule 15c2-11 with which the dealer is demonstrating compliance.

b) In addition, if the dealer is initiating or resuming a priced quote, the firm must specify the basis upon which that quote

[86] Form 211 is filed by companies that want to initiate or resume quotations in an OTC market. By completing the form, firms represent that they have satisfied all requirements of Rule 15c2-11.

was determined. If the quote is initially not priced but is later changed to a priced quote, the firm must supplement its filing with the rationale for the price quoted. Any filings under this rule must be reviewed and signed by a principal of the member firm.

6. FINRA will review the material and, within three business days, notify the dealer whether the application has been cleared. Any deficiencies identified by FINRA must be resolved prior to quoting the security in a quotation medium.

7. There are exceptions to SEC 15c2-11 where the documentation and filing requirements of the rule do not have to be followed.

a) If the security is listed on an exchange or Nasdaq, the rule does not apply.

b) Compliance with 15c2-11 is not required if a dealer is publishing a quotation on behalf of a customer where it represents unsolicited customer interest in buying or selling the security.

8. "The Piggyback Exception," under Rule 15c2-11, applies to securities that have been the subject of regular and continuous securities quotations in a quotation medium for the past 30 days.

SS. The Third Market consists of listed securities traded in the OTC Markets among institutional investors and broker dealers for their own accounts, rather than as agents for investors.

1. Exchanges cannot restrict a member from effecting agency transactions.

2. For securities listed after April 26, 1979, exchange members can act as principals for stocks.[87]

TT.The Fourth Market consists of the Electronic Communication Networks (ECNs).

1. ECNs are execution venues that operate a displayed limit order book.

2. ECNs focus on speed of execution – thee have a small execution size.

3. ECNs don't address institutions' need for block executions

4. Market makers can post on ECNs to fulfill order display obligations.

5. Evolution of ECNs

a) Prior ECNs

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[87] *See* Exchange Act Rule 19c-1 (17 C.F.R. § 240.19c-1); Exchange Act Rule 19c-3 (17 C.F.R. § 240.19c-3).

(1) Island - Merged into Instinet

(2) Instinet - Merged into Nasdaq

(3) BRUT - Merged into Nasdaq

(4) ARCA - Merged with NYSE

b) Current ECNs

(1) BATS Trading - BATS

(2) Bloomberg - TradeBook

(3) Citi - Lava Flow

(4) Knight - DirectEdge

(5) Track Data - TRACK

6. ECNs are governed by Regulation ATS.

a) The ECNs have the discretion to register as an exchange or a broker dealer.

b) If registered as broker dealer, the ECN is governed by Regulation ATS.

c) If registered as an SRO, the ECN must meet the SRO's registration requirements.

UU. Alternative Trading Systems ("ATSs")

1. Regulation ATS established the regulatory classification of an "ATS."

a) Prior to Reg ATS, alternative trading systems were registered as brokers.

2. Generally, firms that cross trades as agent also execute electronically.[88]

3. ECNs are a subset of ATSs.

4. ATS Features

a) Scheduled crosses, meaning that the orders are matched at a predetermined time during the day.

b) Orders are not displayed.

c) All matching buy and sell orders are automatically executed at the cross time.

5. Block ATSs

a) ITG POSIT

b) Liquidnet

[88] In a crossing market, traders submit orders to buy or sell with quantities listed, but not prices. Prices are determined after the order has been submitted.

(1) Allows institutional traders to directly negotiate trades with other institutional traders.

(2) Direct one-to-one negotiations

c) Pipeline

(1) System for block executions only - 25,000-share minimum order size

(2) “Side” not displayed

d) NYFIX

(1) Traditionally an order router

(2) Added NYFIX Millennium to internally cross the reserve portion of customer order.

6. Types of ATSs

a) Scheduled Cross

(1) ITG POSIT

b) Continuous Cross

(1) Liquidnet Negotiation

(2) Liquidnet H2O

(3) ITG BlockAlert

(4) Pipeline

(5) NYFIX

c) Blind

(1) ITG POSIT

(2) Liquidnet H20

(3) NYFIX

d) One-to-one display

(1) ITG BlockAlert

(2) Liquidnet Negotiation

e) Display

(1) Pipeline (side not displayed)

f) Derived Price

(1) ITG POSIT

(2) ITG BlockAlert

(3) Liquidnet H2O

g) Negotiated Price

(1) Liquidnet Negotiation

7. Bulge-brackets evolve; greater conflicts exist due to proprietary trading.

a) Reduced capital commitment

(1) Increased focus on agency trading for customers.

(2) Regulation NMS trade-through rule makes capital commitment outside the spread more difficult, and will further reduce capital commitment.[89]

b) Increased automation

(1) Algorithmic trading

(2) Electronic trading desks

c) Single-broker ATSs - cross retail and institutional flow

(1) Credit Suisse CrossFinder

(2) UBS PIN

(3) Goldman Sigma X

(4) Merrill Lynch Cross Network

(5) Morgan Stanley ATS1 and Pool

(6) Lehman Liquidity Center Cross

(7) Knight Match and KnightMatch 2

(8) BNY ConvergEx Cross and VortEx

VV. Non-Displayed Liquidity

1. ATSs are referred to as “dark pools” or “non-displayed liquidity.”

a) POSIT, Liquidnet, Pipeline, NYFIX

b) CrossFinder

c) LeveL, BIDS

2. The value of non-displayed liquidity.

a) Institutional orders can interact with the market without an adverse market impact.

b) Increased liquidity in market

3. The SEC’s position on transparency as related to dark pools “is that is seeks to encourage the display of trading interest on a fair and non-discriminatory basis,” so while it gives positive incentives for display (such as in Regulation NMS) it does not compel display.[90]

[89] 17 C.F.R. § 242.611(a).

[90] Erik Sirri, Director, Div. of Trading and Markets, SEC, Keynote Speech at the SIFMA 2008 Dark Pools Symposium (Feb. 1, 2008) *available at* www.sec.gov/news/speech/2008/spch020108ers.htm.

4. Dark pools are not new.

   a) Traditionally, the buy-side has pieced out orders to brokers to reduce the amount of information leakage.

   b) The remainder of an order remained “upstairs” at the institutional trading desk, not providing liquidity to anyone and with no hope of getting executed.

   c) Making upstairs liquidity available for execution is an improvement to the market structure

5. Dark pools do not cause fragmentation.

   a) The trend is moving away from manual block trading, where institutional liquidity was highly fragmented upstairs at institutional trading desks.

   b) Institutional liquidity now has the ability to interact with other institutional liquidity through ATSs.

   c) The ATSs are beginning to link, thereby providing greater depth and breadth of liquidity for institutions.

6. Dark pools do not disadvantage retail investors.

   a) Retail orders that can access dark pools get:

      (1) The ability to interact with institutional liquidity that would not otherwise exist;

      (2) Price improvement (block ATSs often provide price improvement to both sides); and

      (3) The ability for retail investors to interact with institutional liquidity in pools operated by brokers that cross institutional and retail liquidity.

   b) ATSs want to interact with retail flow.

      (1) The ATSs are structured to accommodate retail participation while still protecting the institution’s order.

      (2) There is a problem with payment for order flow.

      (3) Are retail brokers meeting best execution when they forego ATSs that can provide price improvement because the ATSs do not pay for order flow?

7. Dark pools do not reduce displayed liquidity.

   a) Institutions use block ATSs and algorithmic trading together to achieve best execution.

   b) Algorithms post and hit displayed liquidity while also accessing block ATSs to reduce market impact.

c) Liquidity is now provided to block ATSs would previously have sat at the buy-side trading desk to protect against adverse market impact.

8. Developments in Dark Pools:

a) In May 2008, BNY ConvergeEx Group launched a new trading desk, VortEx dark pool, offering buy-side clients expanded execution capabilities to provide complete convergence of all major dark pools. The new Dark Desk will serve as a utility for ConvergEx's global sales trading business by enabling it to better leverage dark liquidity execution opportunities for clients and navigate the plethora of dark pools now available. Through its enhanced dark liquidity execution capabilities, the Dark Desk serves as a resource for information on non-displayed liquidity. The ConvergEx Dark Desk serves as a single point of entry for access to every major dark liquidity pool with knowledge of the different characteristics of each pool.

b) In June 2008, Morgan Stanley introduced Night Owl, an electronic trading tool that navigates select dark pool and quoted markets to provide clients with access to the most natural liquidity available. The new algorithm utilizes Morgan Stanley's proprietary analysis of dark liquidity pools to avoid interaction with those dark pools that disclose client information through indications of interest.

c) Europe: Dark pools are on the rise in Europe as a result of a liberalization of the Markets in Finance Instruments Directive ("Mifid") stock trading rules by focusing on improving competition between liquidity venues, as well as the growth of algorithmic trading and the demand for new ways to execute different types of orders.

(1) SWX Europe, a London based platform for the trading of Swiss blue chips, will offer trading of large blocks of stocks on its new facility called Swiss Block. Swiss Block will allow trading in blocks of shares worth more than 500,000 Swiss Francs, which is roughly six times that of an average trade on a European exchange.

(2) Project Turquoise, an equities trading platform, designed by nine major investment banks, consisting of BNP Paribas, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley, Société Générale and UBS. Project Turquoise began limited trading on August 15, 2008. The consortium hopes the system will provide dealing services at a

50% discount to traditional exchanges. Project Turquoise will be a hybrid system that allows trading both on and off traditional exchanges. Specifically, Project Turquoise will allow transactions both on-exchange as well as in "dark pools." Turquoise is scheduled for launch on August 18, 2008.

WW. Direct Market Access ("DMA") Software

1. Allows traders access multiple brokers, ECNs and other venues through one product.

2. Market data from multiple venues is displayed to the user, who can route trades to the appropriate venue for execution.

3. DMA Providers

a) Lava - Acquired by Citibank

b) Sonic - Acquired by BNY

c) Neovest - Acquired by JP Morgan

d) Other brokers have developed in-house direct access systems or purchased existing systems.

4. Algorithmic Trading

a) Algorithmic trading builds on the DMA product.

(1) Uses inputs from historical market data and current market data from various execution venues.

(2) Uses mathematical formulas for determining most efficient execution of an order.

(3) The direct access product routes orders to the appropriate venue for execution.

(4) Requires dissecting an order into pieces to execute a large order over time, and is not a solution for large block executions.

XX. Buy-Side Order Management Systems

1. Order management systems ("OMSs") are software products used by institutions to manage orders. They replace paper-based recordkeeping systems.

2. A portfolio manager enters order in the OMS.

3. An order is assigned to trader in the OMS.

4. The system includes modules for compliance and post-trade processing.

YY. Sell-Side Order Management Systems

1. These OMSs are used by broker dealers (including block trading and market making desks) to handle customer and proprietary orders.

2. Leading sell-side OMSs

ZZ. Financial Information Exchange Protocol ("FIX")

1. Protocol that was agreed upon by financial institutions for exchanging electronic messages.

2. Buy-side traders can use FIX to transmit orders from their OMS to brokers.

3. Brokers use FIX to route orders for execution and report executions back to the institution's OMS.

AAA. The National Market System ("NMS")

1. NMS was established with the goal of utilizing communications and technological advancements in data processing to link the individual markets engaged in the trading of securities and to promote more efficient, fair, and orderly markets.

2. NMS is a computerized link between exchange markets and third-market makers.

3. It routes orders to the location with the best prices, and handles both market and limit orders.

4. Participants must register with FINRA as NMS/CQS market makers in each security they wish to link to the system.

5. Market makers must maintain a continuous two-sided quote in each security.

6. FINRA's Consolidated Quotation System ("CQS")

a) CQS shows bid and ask quotes, with size, for listed equity securities.

b) CQS shows quotes of specialist and CQS-registered market makers.

BBB. Regulation NMS[91]

1. Overview. Regulation NMS was adopted by the SEC in June 2005, with the goal of modernizing the National Market System.[92] The National Market System was first put into place with the adoption of the Securities Acts Amendments of 1975.[93]

a) The Order Protection Rule. Generally, the Order Protection Rule ("OPR") requires broker dealers operating

[91] 17 C.F.R. §§ 242.600 – 612.

[92] Regulation NMS, Exchange Act Release No. 51808, 70 Fed. Reg. 37,496 (June 29, 2005).

[93] *See* Pub. L. 94-29; 15 U.S.C. § 78k-1.

"trading centers" to have policies and procedure reasonably designed to prevent "trade-throughs" of superior prices in other markets when certain specified conditions are met.

b) The Access Rule. The Access Rule strives to provide greater access to quotations by, among other things, requiring certain trading facilities to provide increased access to their quotations, and by limiting fees trading centers may charge for access to quotations.

c) Sub-Penny Rule. In order to promote greater price transparency and consistency, and to protect limit orders, the Sub-Penny prohibits market participants from displaying, ranking, or accepting a bid or offer, order, or indication of interest in NMS stocks priced in an increment less than $.01, if that bid or offer, order, or indication of interest is priced equal to or greater than $1.00 per share.

d) Data Rules and Market Plans. These rules, among other things, allocate revenues to SROs based on various factors related to trades and quotations, rather than just on transaction prints, require the creation of non-voting advisory committees, and permit markets to distribute their own data independently.

2. Order Protection Rule. The Order Protection Rule (Rule 611) aims to prevent trade-throughs by establishing intermarket price protection for automated quotations in NMS stocks displayed by automatic trading centers that are at the top-of-book (best bid to offer) of an exchange, Nasdaq, or the NASD's ADF.[94]

a) Definitions

(1) A "trade-through" is the purchase or sale of an NMS stock during regular trading hours, either as principal or agent, at a price that is lower than a protected bid or higher than a protected offer.[95]

(2) "NMS securities" are securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.[96]

(3) A "trading center" is a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an

[94] 17 C.F.R. § 242.611.

[95] 17 C.F.R. § 242.600(b)(77).

[96] 17 C.F.R. § 242.600(b)(46).

exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.[97]

(4) "Automated quotations" are quotations displayed by a trading center that permits an incoming order to be marked as immediate-or-cancel ("IOC") and immediately and automatically:

> (a) Executes an order marked as IOC against the displayed quotation up to its full size;
>
> (b) Cancels any unexpected portion of an order marked as IOC without routing the order elsewhere;
>
> (c) Transmits a response to the sender of an order marked as IOC indicating the action taken with respect to such order; and
>
> (d) Displays information that updates the displayed quotation to reflect any chance to its material terms.[98]

(5) An "automated trading center" is a trading center (including national securities exchanges, exchange specialists, ATSs, OTC market makers, and block positioners) that has implemented the systems, procedures, and rules necessary to render it capable of displaying quotations meeting the action, response, and updating requirements discussing above in the definition of automated quotations. In addition, to qualify as Automated Trading Center, a trading center must:

> (a) Identify all quotations other than automated quotations as "manual" quotations, and must immediately identify its quotations as manual quotations whenever it has reason to believe that it is not capable of displaying automated quotations; and
>
> (b) Adopt reasonable standards limiting when its quotations change status from automated to manual, and vice-versa, to specifically defined circumstances that promote fair and efficient access to automated quotations and are

[97] 17 C.F.R. § 242.600(b)(78).

[98] 17 C.F.R. § 242.600(b)(3).

consistent with the maintenance of fair and orderly markets.[99]

(6) A protected bid or protected offer (or protected quotation) is a quotation in a NMS stock that:

(a) Is displayed by an automated trading center;

(b) Is disseminated pursuant to an effective national market system plan; and

(c) Is an automated quotation that is the best bid or best offer of a national securities exchange, the best bid or best offer of The Nasdaq Stock Market Inc., or the best bid or best offer of a national securities association other than the best bid or best offer of The Nasdaq Stock market, Inc.[100]

b) Requirements

(1) General Requirements. Trading centers must establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centers, or, if relying on one of the Rule's applicable exceptions, that are reasonably designed to assure compliance with the exception.[101] In addition, trading centers must regularly surveil their operations to test the effectiveness of their policies and procedures and take prompt action to remedy deficiencies.[102]

(2) Exceptions. Under the following circumstances, trading centers may execute orders even if there are superior protected quotations displayed in another market.[103]

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[99] 17 C.F.R. § 242.600(b)(4).

[100] 17 C.F.R. § 242.600(b)(57).

[101] 17 C.F.R. § 242.611(a)(1).

[102] 17 C.F.R. § 242.611(a)(2).

[103] FINRA is authorized under NASD Rule 5150 to exempt firms "from the requirements under NASD Rules to report the applicable trade report modifiers related to SEC Rule 611 of Regulation NMS under the Act, if such exemption is consistent with the protection of investors and the public interest." The exemption cannot exceed six months, and FINRA's exemptive authority will expire on July 9, 2008, one year after the "Pilot Stocks Phase Date," the date for full industry compliance with Rules 610 and 611 for 250 NMS stocks. *See* Order Approving NASD Proposed Rule Changes Relating to Regulation NMS Reporting Requirements, Exchange Act Release No. 55759 (May 15, 2007).

(a) The Self-Help Exception. Trading centers may execute an order without routing to another trading center if the other trading center experiences a failure, material delay, or malfunction in its systems or equipment.[104] For example, a trading center could us this exception if another trading center repeatedly fails to provide an immediate response (within one second) to incoming orders attempting to access its quotes. Trading centers relying on this exception musty notify the non-responding trading center immediately (or at the same time as) selecting self-help pursuant to reasonable and objective standards contained in its policies and procedures.

(b) The Intermarket Sweep Order Exception. Trading centers may execute any order identified as an intermarket sweep order without regard for better-priced protected quotations displayed at other trading centers.[105] Trading centers also are authorized to execute orders internally at prices inferior to protected quotations provided they simultaneously have routed intermarket sweep orders to access all better priced protected quotations at other trading centers.[106]

(c) Exception for Flickering Quotes. Trading centers can use this exception if the trading center displaying the protected quotation that was traded through displayed, within one second prior to the execution of the trade through, a best bid or offer for the NMS stock with a price equal or inferior to the price of the trade-through transaction.[107] This exception thus provides a one-second window to address false indications of trade-throughs that in actuality are attributable to rapidly moving quotations.

[104] 17 C.F.R. § 242.611(b)(1).

[105] 17 C.F.R. § 242.611(b)(5). Intermarket Sweep Orders allow broker dealers to sweep through multiple price levels at a particular trading center as long as they simultaneously route orders to execute against the displayed size of all better-priced protected quotations.

[106] 17 C.F.R. § 242.611(b)(6).

[107] 17 C.F.R. § 242.611(b)(8).

(d) Exception for Single-Price Openings, Reopenings, Reopenings, and Closing Transactions. A trade through is exempted from the OPR if it was a single-priced opening, reopening, or closed transaction by the trading center.[108] To use this exception, trading centers must conduct formalized and transparent processes for executing orders during reopening after a trading halt that involves the queuing and ultimate execution of multiple orders at a single equilibrium price.[109] Trading centers must also have formally declared a trading halt pursuant to their rules or written procedures.[110]

(e) Exception for Benchmark Trades. Trading centers may execute volume-weighted average price ("VWAP") orders, as well as other types of orders that are not priced with reference to the quoted prices of NMS stocks at time of execution and for which the material terms were not reasonably available at the time the commitment to execute the order was made.[111]

(f) Exception for Stopped Orders. This exception applies to the execution by a trading center of a stopped order for the account of a customer when the price of the execution of the order was lower (for a buy order) than the national best bid at the time of execution or was higher (for the sell order) than the national best offer at the time of execution.[112] The customer must have agreed to the stop price on an order-by-order basis.

(g) Exception for Other Than "Regular-Way" Contracts. This exception applies to transactions that are executed other than pursuant to standardized terms and conditions,

[108] 17 C.F.R. § 242.611(b)(3).

[109] Regulation NMS, Exchange Act Release No. 51808 at 95, 70 Fed. Reg. 37,496 (June 29, 2005).

[110] Regulation NMS, Exchange Act Release No. 51808 at 95-96, 70 Fed. Reg. 37,496 (June 29, 2005).

[111] 17 C.F.R. § 242.611(b)(7).

[112] 17 C.F.R. § 242.611(b)(9).

such as transactions that have extended settlement terms.[113]

(h) Exception for crossed Quotations. Transactions executed when protected quotations were crossed are excepted from the OPR.[114] This exception does not apply, however, when a protected quotation crosses a non-protected quotation.

(i) Exemption for certain Sub-Penny Trade-Throughs. By order, the SEC provided an exemption from the OPR for trades where: (1) the price of the protected quotation that is traded through is $1.00 or less; and (2) the price of the trade through transaction is less than $0.01 away from the price of the protected quotation that was traded through.[115]

(j) Exemption for Contingent Trades. By order, the SEC granted an exemption from the OPR for "trade-throughs caused by the execution of an order involving one or more NMS stocks (each an 'Exempted NMS Stock Transaction') that are components of a qualified contingent trade."[116] A "qualified contingent trade" is a transaction consisting of two or more component orders, executed as agent or principal, where:

(i) At least one component order in an NMS stock;

(ii) All components are effected with a product or price contingency that either has been agreed to by the respective counter parties or arranged for by a broker dealer as principal or agent;

(iii) The execution of one component is contingent upon the execution of all other components at or near the same time;

[113] 17 C.F.R. § 242.611(b)(2).

[114] 17 C.F.R. § 242.611(b)(4).

[115] Order Exempting Sub-Penny Trade-Throughs from Rule 611 of Regulation NMS, Exchange Act Release No. 54678 (Oct. 31, 2006).

[116] Order Granting Exemption for Qualified Contingent Trades from 611(a) of Regulation NMS, Exchange Act Release No. 54389 (Aug. 31, 2006).

(iv) The specific relationship between the component orders (e.g., the spread between prices of the component orders) is determined at the time the contingent order is placed;

(v) The component orders bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or since cancelled;

(vi) The Exempted NMS Stock Transaction is fully hedged (without regard to any prior existing position) as a result of the other components of the contingent trade; and

(vii) The Exempted NMS Stock Transaction that is part of a contingent trade involves at least 10,000 shares or has a market value of at least $20,000.[117]

(k) Exemption for Print Protection Transactions. By order, the SEC provided an exemption from the OPR fro "print protection transactions." A print protection transaction is executed of an order that satisfies the following requirements:

(i) The order is displayed in whole or in part by an automated trading center that displays protected quotations;

(ii) After the order is displayed, a transaction ("Triggering transaction") is reported pursuant to a transaction reporting plan at a price that is inferior to the price of the displayed order;

(iii) The triggering transaction is reported as qualifying for the exception for ISOs under Rule 611(b)(5) or (b)(6);

[117] Order Granting Exemption for Qualified Contingent Trades from 611(a) of Regulation NMS, Exchange Act Release No. 54389 (Aug. 31, 2006).

(iv) The trading center executes the order promptly after the triggering transaction is reported;

(v) The contra side of the execution of the order is provided by a broker dealer who has responsibility for the order;

(vi) The size of the transaction does not exceed the total of the displayed size and reserve size of the order displayed on the automated trading center; and

(vii) The trading center establishes, maintains, and enforces written policies and procedures that are reasonably designed to assure compliance with terms of this exemption, and the trading center regularly surveils to ascertain the effectiveness of such policies and procedures and takes prompt action to remedy deficiencies in them.[118]

(l) Exemption for Error Correction Transactions. By order, the SEC provided an exemption from the OPR for "error correction transactions,' which are defined as transactions that meet the following terms and conditions:

(i) The trading center effects the transactions solely to correct a "bona fide error,"[119]

(ii) The bona fide error is evidenced by objective facts and circumstances, and the trading center maintains documentation of such facts and circumstances;

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[118] Order Exempting Certain Print Protection Transactions from Rule 611 of Regulation NMS, Exchange Act Release No. 55883 (June 8, 2007).

[119] "Bona fide errors" are defined as "(i) the inaccurate conveyance or execution of any term of an order including, but not limited to, price, number of shares or other unit of trading; identification of the security; identification of the account for which securities are purchased or sold; lost or otherwise misplaced order tickets; short sales that were instead sold long or vice versa; or the execution of an order on the wrong side of a market; (ii) the unauthorized or unintended purchase, sale, or allocation of securities, or the failure to follow specific client instructions; (iii) the incorrect entry of data into relevant systems, including reliance on incorrect cash positions, withdrawals, or securities positions reflected in an account; or (iv) a delay, outage, or failure of a communication system used to transmit market data prices or to facilitate the delivery or execution of an order." Order Exempting Certain Print Protection Transactions from Rule 611 of Regulation NMS, Exchange Act Release No. 55883 (June 8, 2007).

(iii) The trading center records the transaction in its error account;

(iv) The trading center establishes, maintains, and enforces written policies and procedures that are reasonably designed to address the occurrence of errors and, in the event of an error, the use and terms of a transaction to correct the error in compliance with this exemption; and

(v) The trading center regularly surveils to ascertain the effectiveness of its policies and procedures to address errors and transactions to correct errors and takes prompt action to remedy deficiencies in such policies and procedures.[120]

3. Access Rule

a) Fair and Non-Discriminatory Access

(1) The Access Rule (Rule 610) requires SRO trading facilities to provide fair and non-discriminatory access to their quotations to any person indirectly obtaining access to those quotations through members, subscribers, or customers of those trading facilities.[121] The unfair discrimination standard, including access fees charged, applies only to access to quotations, and not to their members.[122] In addition, differential fees, such as volume-based discounts, are permissible so long as they do not vary based upon the non-member status of a person obtaining indirect access to quotations.[123]

(2) In addition, all trading centers that choose to display quotations in an SRO display-only quotation facility must provide "a level and cost of access to such quotations that is substantially similar to the level and cost of access to quotations displayed by SRO trading facilities in that stock."[124] These

[120] Order Exempting Certain Print Protection Transactions from Rule 611 of Regulation NMS, Exchange Act Release No. 55883 (June 8, 2007).

[121] 17 C.F.R. § 242.610(a).

[122] Regulation NMS, Exchange Act Release No. 51808 at 200, 70 Fed. Reg. 37,496 (June 29, 2005).

[123] Regulation NMS, Exchange Act Release No. 51808 at 170, 70 Fed. Reg. 37,496 (June 29, 2005).

[124] 17 C.F.R. § 242.610(b)(1).

additional requirements only arise, however, if a trading center displays its quotations in the consolidated data stream and does not provide access through an SRO trading facility.

b) Access Fees

(1) The Access Rule also limits the fees any trading center can charge, or allow to be charged, for accessing its protected quotations, both displayed and reserve, to no more than $0.003 per share.[125] The Rule also applies fee limitations to quotations other than protected quotations that are the best bids or offers of an SRO, the ADF, or Nasdaq (e.g., for manual quotations at the best bid or offer).[126]

(2) Fees not triggered by the execution of orders against protected quotations or best bid or offer quotations, such as periodic fees, generally are not subject to the Rule.

c) Locked and Crossed Quotations

(1) The Access Rule also requires SROs to establish, maintain, and enforce written rules that:

(a) Require their members reasonably to avoid displaying quotations that lock or cross protected quotations in NMS stocks or displaying manual quotations that lock or cross any quotation in an NMS stock disseminated pursuant to an effective national market system plan;

(b) Are reasonably designed to assure the reconciliation of locked or crossed quotations in an NMS stock; and

(c) Prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross automated quotations of other trading centers.[127]

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[125] 17 C.F.R. § 242.610(c). If the price of a protected quotation is less than $1.00, the fee cannot exceed 0.3% of the quotation price. *Id*.

[126] In the final rule, the SEC extended the fee cap to apply to any quotation that is the best bid or offer of an exchange, the ADF, or the Nasdaq Market Center (rather than protected quotations only) to preclude any incentive for trading centers to display manual quotations as a means to charge a higher access fee. In addition, the SEC recognized that, at present, a trading center's execution quality statistics will be evaluated against the NBBO, whether that quotation is manual or automated. Regulation NMS, Exchange Act Release No. 51808 at 190-91, 70 Fed. Reg. 37,496 (June 29, 2005).

[127] 17 C.F.R. § 242.610(d).

(2) Trading centers are, however, permitted to display automated quotations that lock or cross manual quotations.

(3) In addition, if an SRO's rules provide for reasonable exceptions to the locking and crossing requirements, the prohibition against locking and crossing protected quotations will not apply.[128]

d) Regulation ATS Fair Access Requirements. Regulation NMS also modified the fair access requirements of Regulation ATS Rule 301(b)(5) to lower the threshold that triggers such requirements from 20% of the average daily volume in a security to 5%. Aside from lowering the threshold, substantive requirements of Rule 301(b)(5) were left unchanged.[129]

4. Sub-Penny Rule

a) The Sub-Penny Rule (Rule 612) generally prohibits market participants from displaying, ranking, or accepting a bid or offer, order, or an indication of interest in NMS stock priced in an increment less than $0.01 if that bid or offer, order, or indication of interest is priced equal to or greater than $1.00 per share.[130] If the price of the quotation is less than $1.00 per share, the minimum permissible increment is $0.0001.[131]

b) Market participants are also prohibited from accepting a sub-penny order or quotation that is not permitted under the Rule, even if it rounds the order or quotation to the nearest permissible pricing increment.[132] The rule does not prohibit a sub-penny execution resulting from a midpoint or volume-weighted algorithm or from price improvement, however, "so long as the execution does not result from an impermissible sub-penny order or quotation."[133]

5. Market Data Rules

a) Revised Revenue Allocation Formula. Regulation NMS alters the Market Data Rules (Rules 601 and 603) and the joint industry plans ("Plans") to reward the contribution quotes make to public price discovery and to discourage

[128] 17 C.F.R. § 242.610(d)(3).

[129] Regulation NMS, Exchange Act Release No. 51808 at 208, 70 Fed. Reg. 37,496 (June 29, 2005).

[130] 17 C.F.R. § 242.612(a).

[131] 17 C.F.R. § 242.612(b).

[132] Regulation NMS, Exchange Act Release No. 51808 at 232, 70 Fed. Reg. 37,496 (June 29, 2005).

[133] Regulation NMS, Exchange Act Release No. 51808 at 231, 70 Fed. Reg. 37,496 (June 29, 2005).

wash sales, trade shredding, and similar practices.[134] Specifically, the new Plan formula allocates revenues to the various SROs based on both, trades and quotations, rather than only trades as previously.[135]

b) Establishment of Advisory Committees. The Market Access Rules broaden participation in Plan governance by requiring the creation of non-voting advisory committees composed of non-SRO representatives. The advisory committee must be composed of, at minimum, one or more representatives associated with:

(1) A broker dealer with a substantial retail investor base;

(2) A broker dealer with a substantial institutional investor base;

(3) An ATS;

(4) A data vendor; or

(5) An investor.[136]

c) Distribution and Display of Market Data

(1) The Market Access Rules also authorize markets to distribute their own data independently and streamline requirements for the display of market data to investors. Markets must, however, continue to provide their best quotations and trades for consolidated dissemination through the Plans. All SROs must act jointly through the Plans and through a single processor per security to disseminate consolidated market information.[137]

(2) The new rules also reduce and simplify the consolidated display requirements by reducing the data required to be displayed and limiting the display requirements to trading and order-routing contexts.[138] The new definition of “consolidated display” is limited to the prices, sizes, and market center identifications of the NBBO and the “consolidated last sale information.”[139]

[134] Regulation NMS, Exchange Act Release No. 51808 at 264-65, 70 Fed. Reg. 37,496 (June 29, 2005).

[135] Regulation NMS, Exchange Act Release No. 51808 at 252, 70 Fed. Reg. 37,496 (June 29, 2005).

[136] Regulation NMS, Exchange Act Release No. 51808 at 437, 70 Fed. Reg. 37,496 (June 29, 2005).

[137] 17 C.F.R. § 242.603.

[138] 17 C.F.R. § 242.603.

[139] 17 C.F.R. § 242.600(b)(13).

6. Industry Implementation

a) Guidance on Data Handling. Firms have sought guidance on how much data must be maintained to comply with Regulation NMS and with related examination requests.

(1) In response, the SEC has stated, for example, that compliance with the Order Protection Rule will be assessed, "[a]ssuming reasonable data handling policies and procedures," on the basis of two kinds of data: (1) "Firm-Specific Order and Trade Data" (i.e., "the order and trade data of each trading center or broker dealer ('Firm'), with internal time stamps reflecting when it was processed by each Firm") and (2) "Firm-Specific Quotation Data" (i.e., "the protected quotation data received by each Firm, with internal time stamps reflecting when it was received by the Firm"). Nevertheless, the SEC emphasized that "Network Data" (i.e., "the protected quotation and trade data of the Network processors, with time stamps assigned by such processors") is the "single available common reference point for quotations and trades in NMS stocks." And such, "may be used by regulatory authorities, as an initial matter, to gauge [Firms] compliance with [the Order Protection Rule] generally."[140]

(2) The SEC also has made clear that the Order Protection Rule does not require the maintenance of a comprehensive database of Firm-Specific Quotation Data as long as two conditions are met; (1) the Firm has implemented reasonable prices and procedure that include periodic review of its compliance with Rule 611, and (2) the Firm retains sufficient Firm-Specific Quotation Data to demonstrate the reasonableness of its Rule 611 compliance reviews in light of its individual characteristics, including its volume of trading and routing. Firms generally are required, therefore, to conduct periodic reviews for specific time periods and to maintain all relevant "snapshots" of the Firm-Specific Quotation Data from those days that are necessary to demonstrate the reasonableness of its policies and procedures to regulators.

[140] Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS, SEC, http://www.sec.gov/divisions/marketreg/nmsfaq610-11.htm.

b) SROs' Uniform Rules on Locked and Crossed Markets. Notably, the SROs have adopted uniform rules to deal with locked and crossed markets.

CCC. Clearance and Settlement

1. Rule 15c6-1[141]

a) The SEC adopted Rule 15c6-1 to "facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities."[142]

b) Rule 15c6-1 provides, "a broker or dealer shall not effect or enter into a contract for the purchase or sale of a security (other than an exempted security, government security, municipal security, commercial paper, bankers' acceptances, or commercial bills) that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction."[143]

2. Coverage

a) Rule 15c6-1 covers all securities, except for exempted securities (including government securities and municipal securities, commercial paper, bankers' acceptances, or commercial bills).

b) In addition, the rule specifically exempts sales of unlisted partnership interests.

c) The SEC has granted an exemption for securities that do not generally trade in the U.S.

d) The SEC also exempted from Rule 15c6-1 a contract for purchase for the purchase or sale of any security issued by an insurance company that is funded by or participates in a separate account, including a variable annuity contract or a variable life insurance contract, or any other insurance contract registered as a security under the Securities Act of 1933 ("Securities Act").

3. Offerings

a) Rule 15c6-1 provides a T+4 (trade date + 4) settlement cycle in firm commitment underwritings for securities that are priced after 4:30p.m Eastern Time, which enables market participants to satisfy prospectus delivery.

[141] 17 C.F.R. § 240.15c6-1.

[142] 17 C.F.R. § 240.15c6-1.

[143] 15 U.S.C. 78q-1(a)(2).

4. Clearance and settlement can be accomplished by broker dealers through a registered clearing agency, which completes the securities transaction. Clearing agencies are SROs as well.

a) Clearing agencies must register with the SEC under Rule 17Ab2-1.[144]

b) A clearing corporation compares member transactions, clear trades, and prepares instructions for automated settlement of those trades. Examples includes National Securities Clearing Corporation ("NSCC"), Fixed Income Clearing Corporation, and Options Clearing Corporation.

c) A depository holds securities certificates for participants and maintains ownership records. An example is the Depository Trust Corporation.

d) Broker dealers become clearing members of relevant clearing agencies. Smaller broker dealers typically lack the financial resources to join clearing agencies, and establish a corresponding relationship with a clearing broker.

e) Clearing corporations instruct depositories to make delivery of securities upon settlement.

f) Trade comparison assures that the buy and sell side components of a trade agree. Most trades arrive at the NSCC "locked in" – that is, effectively matched.

g) Broker dealers report the details of a trade to the NSCC, which matches buyers with their stated seller.

5. Matches are made based upon:

a) The market in which trade was executed;

b) The trade date (T);

c) The CUSIP (ID code given to each class and issue of security);

d) The quantity;

e) The price; and

f) Which side (buy or sell) the broker dealer is on.

6. On the day after the trade date (T+1), NSCC issues contract sheets indicating the status of efforts to match trades.

a) "Compared" indicates no further action is needed prior to settlement.

b) "Uncompared" or "advisory" indicates details submitted by buyer and seller do not match. Further action is needed.

[144] 17 C.F.R. § 240.17Ab2-1.

7. Day T+2 is the last day to reconcile trades, otherwise the trade is dropped from comparison.

8. Settlement is the delivery of securities by the seller and the delivery of funds by the purchaser. This occurs several days after trade has been consummated.

9. The Continuous Net Settlement ("CNS") System nets the delivery and payment obligations of all members of the clearing corporation. Most trades are cleared and settled this way.

10. Day T+3 is the Settlement Date. Participants in the trade instruct the depository to credit or debit their accounts accordingly, without the need for moving stock certificates.

DDD. Regulation SHO[145]

1. A short sales occurs when a customer sells securities that he or she does not own by borrowing them from the broker dealer and delivering them to the clearing agency. If the price does not fall and the customer fails to cover, then the broker dealer must cover.

2. On July 28, 2004, the SEC adopted new Regulation SHO under the Exchange Act[146] to update short sale regulation in light of numerous developments in the market since short sale regulation was first adopted in 1938.

a) Rule 10a-1[147] prohibited a broker dealer from effecting short sales where the last sale price was lower than the immediately previous one (to bar short selling in a falling market).

b) Regulation SHO relaxed some of the restrictions on effecting short sales, notably by suspending a "tick" or "bid" test for a subset of actively-traded securities and for after-hours short sales of other securities on a one-year pilot basis.

c) Regulation SHO modified the then-current marking requirements.

d) Regulation SHO imposed new restrictions, including a uniform "locate" requirement for short sales in all equity securities (i.e., all exchange-listed and OTC securities) and an additional "close-out" requirement on designated "threshold securities" that have substantial settlement failures.

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[145] 17 C.F.R. §§ 242.200 – 203.

[146] *See* Short Sales, Exchange Act Release No. 50103, 69 Fed. Reg. 48,008 (Aug. 6, 2004).

[147] 17 C.F.R. § 240.10a-1.

e) The SEC concurrently published amendments to Rule 105 of Regulation M,[148] which generally prohibits covering short sales effected immediately prior to the pricing of an offering with securities received in the offering.

3. The Pilot Program

a) Regulation SHO included temporary Rule 202T,[149] establishing procedures to allow the SEC to institute a pilot program ("Pilot") suspending the "tick test" of Rule 10a-1 and any short sale price test of any exchange or national securities association for one-third of the securities in the Russell 3000 index. This enabled the SEC to study the utility and effectiveness of the "tick test" in connection with short sales in order to assess whether changes to current short sale regulations were necessary in light of current market practices.

(1) The Pilot only suspended the operation of the price test. The other provisions of Regulation SHO – including marking, locate, and delivery requirements – remained in effect.

(2) The SROs actively monitored trading in Pilot securities to identify any abusive short selling.

4. Rule 200 – Ownership Definition and New Marking Requirements[150]

a) Rule 200 of Regulation SHO largely incorporated former Rule 3b-3, with some modifications.

b) One modification was the transfer of the requirement to mark sales "long" or "short" from Rule 10a-1 to Rule 200.

(1) As amended, Rule 200(g) specified that an order could only be marked "long" when the seller owned the security being sold, and the security was either in the physical possession or control of the broker dealer, or it was reasonably expected that the security would be in the physical possession or control of the broker dealer prior to settlement.[151]

(2) This requirement was more stringent than the former language of Rule 10a-1(d), which only required the broker dealer to be informed that the seller owned the security to be sold, and that the security would be

[148] 17 C.F.R. § 242.105.

[149] 17 C.F.R. § 242.202T.

[150] 17 C.F.R. § 242.200.

[151] 17 C.F.R. § 242.200(g).

delivered to the account for which the sale was effected "as soon as possible without undue inconvenience or expense."

c) If a person either did not own the security being sold, or owned the security but did not believe it would be in the physical possession or control of the broker dealer prior to settlement, the sale must be marked "short."[152]

d) Rule 200 also codified a prior SEC no-action position allowing broker dealers to aggregate their positions within defined trading units.

(1) As amended, the conditions for the aggregation unit exception had been slightly relaxed.

e) As adopted, Rule 200(f)[153] permits trading unit aggregation if a broker dealer meets the following requirements:

(1) The broker dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity;

(2) Each aggregation unit within the firm determines its net position for every security that it trades at the time of each sale;

(3) All traders in an aggregation unit pursue only the trading objectives or strategies of that aggregation unit; and

(4) Individual traders are assigned to only one aggregation unit at a time

f) The SEC declined to extend the concept of aggregation unit netting to include non- broker dealers.

g) For firms not relying on the aggregation unit exception, the SEC stated, current technology allows firms to aggregate their firm-wide positions on a real-time basis. However, to the extent that a firm is unable to accomplish real-time aggregation on a firm-wide basis, it should be able to demonstrate why such aggregation is impracticable and that the alternative method employed (e.g., on a daily basis) accurately reflects firm ownership positions.

[152] Prior to the recent amendments by the SEC, Regulation SHO provided that a sale may be marked "short exempt" if the seller was entitled to rely on an exception from the tick test of Rule 10a-1, or the price test of an exchange or national securities association (orders marked "short exempt" may still need to comply with the locate requirement). Short sales of securities included in the Pilot were to be marked "short exempt."

[153] 17 C.F.R. § 242.200(f).

5. Uniform "Locate" Requirement

a) Rule 203(b) of Regulation SHO[154] replaced existing SRO rules (e.g., NASD Rule 3370 and NYSE Rule 440C) and created a uniform SEC rule requiring a broker dealer, prior to affecting a short sale in any equity security, to "locate" securities available for borrowing.

b) Specifically, Rule 203(b) prohibits a broker dealer from accepting a short sale order in any equity security from another person or effecting a short sale order for the broker dealer's own account unless the broker dealer has:

(1) Borrowed the security, or entered into an arrangement to borrow the security; or

(2) Has reasonable ground to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and

(3) Has documented compliance with the rule.

c) The methods of satisfying reasonable grounds are as follows:

(1) Reliance on an "easy to borrow" list, provided the information used to generate the list is less than 24-hours old and the securities on the list are so readily available that fails-to-deliver are unlikely (reliance on the fact that a security is not on a "hard to borrow" list is not sufficient); or

(2) Reliance on a customer's assurance that a "locate" was received from another source (e.g., a prime broker), provided the broker dealer documents the customer's source, and prior assurances from such customer did not result in fails-to-deliver.

d) There is an exception from the "locate" requirement of Rule 203(b) for short sales in connection with "bona fide" market making.

e) The SEC provides guidance in the Release on trading activity that would not constitute bona fide market making:

(1) Activity that is related to speculative selling strategies of the broker dealer and is disproportionate to the broker dealer's usual market making patterns or practices;

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[154] 17 C.F.R. § 242.203(b).

(2) Activity whereby the market maker posts continually at or near the best offer but not also at or near the best bid; or

(3) Transactions whereby the market maker enters into an arrangement with another broker dealer or customer to use the market maker's exception to avoid compliance with the locate requirement.

f) Other exceptions from the "locate" requirement are:

(1) An executing broker dealer that accepts a short sale order from another registered broker dealer, absent a contractual undertaking by the executing broker dealer to perform a locate; and

(2) The sale of a security that a person owns, but will not be able to deliver by settlement date (e.g., sales of formerly restricted stock, convertibles options, or warrants tendered for conversion or exchange), provided that such person must deliver the security within at least 35 days, or else the broker dealer that effected the sale must either borrow securities or close-out the customer position by purchasing securities.

g) The SEC did not incorporate into Regulation SHO the current exception in NASD Rule 3360 for short sales that result in bona fide hedged or arbitraged positions, nor did it include an exception for transactions in exchange-traded funds.

6. Close-Out Requirement for Threshold Securities

a) Regulation SHO defines "threshold securities" as equity securities of reporting issuers where:

(1) The security has aggregate fails-to-deliver at a registered clearing agency of 10,000 shares or more for 5 consecutive settlement days; and

(2) The aggregate fails-to-deliver is equal to at least 0.5% of the issue's total shares outstanding.[155]

b) A list of threshold securities is calculated and disseminated daily by the SRO on which the security is listed or for which the SRO bears primary surveillance responsibility.

c) Rule 203(b)(3) requires a participant of a registered clearing agency (e.g., generally clearing brokers) to close

[155] 17 C.F.R. § 242.203(b)(3).

out any fail-to-deliver position in a threshold security (whether caused by a long or short sale) that has remained for 13 consecutive settlement days, namely by purchasing securities of like kind and quantity, unless it qualifies for an exception.[156]

d) In order to be deemed to have met such close-out requirements, the participant must not know or have reason to know that the counterparty from whom the participant purchases securities will not deliver the securities (i.e, a participant may not enter into an arrangement with a counterparty to evade the rule by simply transferring the fail in the CNS system).

e) Self-executing restrictions are triggered if the participant does not take action to close out the open fail-to-deliver position.

f) Specifically, under Rule 203(b)(3)(iii), any such participant and any broker dealer for which it clears (including any market maker) is prohibited from effecting further short sales in the particular threshold security without first borrowing or arranging to borrow the security (as opposed to only obtaining a "locate").[157]

g) If a clearing broker can identify the account(s) which contributed to the fail-to-deliver position, this restriction would only apply to such account(s).

h) There is no exception from the close-out requirement for "bona fide" market making short sales.

i) The rule makes clear, however, that the close-out requirement does not apply to fail-to-deliver positions established prior to the particular security becoming a threshold security.[158]

j) It also does not apply to fail-to-deliver positions attributable to an options market maker selling short to hedge options positions created before the security became a threshold security.

7. Delivery Requirements for Long Sales

   a) Rule 203(a)[159] of Regulation SHO incorporates former Rule 10a-2 and extends the requirements of the rule to all equity securities.

[156] 17 C.F.R. § 242.203(b)(3).

[157] 17 C.F.R. § 242.203(b)(3)(iii).

[158] 17 C.F.R. § 242.203(b)(3)(iii).

[159] 17 C.F.R. § 242.203(a).

b) As adopted, the rule prohibits a broker dealer from failing to deliver, or from lending securities to ensure a fail-to-deliver does not occur.

c) There are several exceptions, including where a broker dealer knows or has been reasonably informed that the seller will deliver the security prior to settlement, but such delivery does not occur.[160]

d) Note, however, the statement in the Release that "It may be unreasonable for a broker dealer to treat a sale as long where orders marked 'long' from the same customer repeatedly require borrowed shares for delivery or result in fails to deliver."[161]

8. Rule 105 of Regulation M – Short Sales in Connection with a Public Offering[162]

a) The SEC published concurrently with Regulation SHO an amendment to Rule 105 of Regulation M, which generally prohibits the covering of short sales effected within a five-day period prior to pricing of an offering with offering securities purchased from an underwriter or broker dealer participating in the offering.[163] The specific amendment eliminates the current exception for shelf offerings.

9. SEC and NYSE Amendments Concerning Short Sale Rules

a) On December 2006, the Commission, based on a careful study of the pilot program results and the status of current price test restrictions, proposed amendments to certain rules governing short sales.

b) On June 28, 2007, the SEC issued a release adopting amendments to its rules governing short sales (the "Adopting Release").[164] The amendments became effective upon publication in the Federal Register on July 3, 2007, with a July 6, 2007, compliance date. Subsequently, FINRA and NYSE made confirming amendments to their related rules.[165]

c) Specifically, the SEC amendments eliminate Rule 10a-1 under the Exchange Act.

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[160] 17 C.F.R. § 242.200(g)(1)(i).

[161] Short Sales, Exchange Act Release No. 50103 at n. 111, 69 Fed. Reg. 48,008 (Aug. 6, 2004).

[162] 17 C.F.R. § 242.105.

[163] 17 C.F.R. § 242.105(a)(1)

[164] Regulation SHO and Rule 10a-1, Exchange Act Release No. 55970, 72 Fed. Reg. 36,348 (July 3, 2007).

[165] NYSE 2007-62 (Feb 1, 2008) and FINRA 2007-025(Feb. 7 2008) (changes to, among other things, Rules 421, 440F and 440G) and NASD 2007-047 (Aug. 24, 2007) (changes to, among other things, NASD 3360).

d) Additionally, the amendments add Rule 201 of Regulation SHO[166] to provide that no price test, including any price test by any self-regulatory organization ("SRO"), shall apply to short selling in any security.

e) Rule 200(g) of Regulation SHO,[167] as amended, no longer contains the requirement that a broker dealer mark a sell order of an equity security as "short exempt" if the seller is relying on an exception from Rule 10a-1, or any price test of any exchange or national securities associations, as this rule is no longer necessary with the elimination of the price test requirements.[168]

f) On August 7, 2007, the SEC adopted amendments to Regulation SHO that: (1) eliminated the grandfather provision, under which the close-out requirement under Rule 203(b)(3) did not apply to positions that were established prior to the security becoming a threshold security; (2) extended the close-out requirement from 13 to 35 consecutive settlement days for fails-to-deliver resulting from sales of threshold securities pursuant to Rule 144 of the Securities Act; and (3) clarified how the 2% limitation is to be calculated for purposes of the market decline limitation under Rule 200(e)(3).[169] Also, on August 7, 2007, the SEC proposed the elimination of the options market maker exception and proposed amending the long sale marking provisions of Rule 200(g)(1).[170]

EEE. Trading

1. Buy-Side Firm

a) An investment advisor:

(1) Manages mutual funds and other managed accounts

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[166] 17 C.F.R. § 242.201.

[167] 17 C.F.R. § 242.200(g).

[168] The SEC has issued a no-action letter to the American Stock Exchange LLC which states that, based on facts presented and representations made, the Division of Market Regulation will not recommend enforcement action under Rule 200(g) if an SRO continues to accept orders marked as "short exempt" for a period of ninety days from the July 6, 2007 compliance date of the amendments. *See* Letter from Josephine Tao, Assistant Director, Division of Market Regulation, SEC, to Jeffrey P. Burns, Vice President and Associate General Counsel, American Stock Exchange LLC (July 2, 2007) *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2007/amex070207-sho.pdf.

[169] Amendments to Regulation SHO, Exchange Act Release No. 56212, 72 Fed. Reg. 45,544 (Aug. 14, 2007).

[170] Amendments to Regulation SHO, Exchange Act Release No. 56213, 72 Fed. Reg. 45,558 (Aug. 14, 2007).

(2) Portfolio manager

(a) Makes investment decisions

b) A buy-side trader:

(1) Determines how to execute trade;

(2) Has limited options for executing trades; and

(3) Sends order to a block trading desk.

2. Sell-Side Firm

a) A broker dealer block trading desk:

(1) Receives order from buy-side trader; and

(2) Has the following methods for executing trades:

(a) Route order to an exchange or market maker for execution (market maker often affiliated/payment for order flow);

(b) Execute as a principal against the customer (capital commitment/facilitation); and

(c) Cross trade as an agent against another customer of block trading desk.

3. Issues – Information dissemination

a) Block traders call other customers and other brokers.

b) Block traders send electronic indications of interest ("IOIs") out to the market.

c) Block traders post orders on an exchange or with market maker.

4. Information dissemination results in adverse price movement incurred by the institution.

a) Lack of liquidity

(1) Institutional order size is large relative to the average execution size in the market.

(2) An institution exposes only small portion of its order to market.

(3) A broker exposes only small portion of that portion to the market.

(4) Institutions who are contra-parties are unable to match their block orders.

b) High transaction costs

(1) High commissions

(2) No price improvement

(a) Execute at the bid or offer of NBBO

(3) Market impact cost

c) Conflicts of interest

(1) A block trading desk trades for itself and for customers.

(2) There is the potential for front-running.

(3) Directing orders to brokers that distribute institution's mutual funds

FFF. Regulatory Issues

1. Best execution

a) Duty of best execution evolves with changes in technology.

b) What are a broker's best execution obligations in the current trading environment?

c) Does best execution require a broker to utilize algorithms and access dark pools?

d) Must brokers purchase depth-of-book market data from all markets?

2. Erroneous trades

a) Program trading and algorithms can increase the risk of erroneous trades.

b) An exchange can cancel erroneous trades executed on or reported to the exchange.

(1) This included trades executed off-exchange (i.e., on an ATS) and reported to an exchange.

3. Market manipulation

a) Can traders use dark pools to facilitate market manipulation?

b) Trades could execute a smaller order on the exchange and a larger opposite-side order in a dark pool.

(1) Similar concern exists in the manual trading environment.

4. Insider trading

a) All off-exchange executions are reported to the tape.

(1) Ex: Nasdaq TRF

5. In an electronic trading environment, all order events are audit-trailed.

VIII. OVERVIEW OF REGISTRATION OF SECURITIES

A. Absent an exemption, Section 5[171] of the Securities Act[172] prohibits offers and sales of securities unless registered.

B. If an issuer or underwriter offers or sells a security, it must use the registration process unless it is a private placement under Section 4(2), a Regulation S offering, or an exempt security is involved.

C. Section 2(a)(4)[173] defines an "issuer" as every person who issues or proposes to issue a security. Issuers must register all sales and resales of previously publicly traded securities – e.g., an issuer cannot purchase shares of its own stock on an exchange and later resell those shares without registration (unless there is an exemption).

D. Except for "well-known seasoned issuers" ("WKSIs"), registration requires that a registration statement covering a security be filed before any offer is made. Pursuant to Rule 163,[174] WKSIs may make offers before a registration statement is on file.

E. For all issuers, only written materials (including "free writing prospectuses") that meet the requirements of Section 10[175] may be used to promote the offering.[176]

F. Registration statements must be "effective" before any sale is made.

G. Section 2(a)(11)[177] defines an "underwriter" as any person who has purchased a security (1) from an issuer (or any person who offers or sells a security for an issuer) or (2) from "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer,"[178] in either case with a view to distribution of the security.

1. The definition includes a managing underwriter and other members of an underwriting syndicate.

2. It excludes dealers who are selling group members

3. Section 2(a)(11) and Rule 141[179] provide that, if a person's interest in the sale of a security is limited to a commission from an underwriter (but not from the issuer) which is not in excess of a

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[171] 15 U.S.C. § 77e.

[172] 15 U.S.C. § 77a *et seq*.

[173] 15 U.S.C. § 77b(a)(4).

[174] 17 C.F.R. § 230.163.

[175] 15 U.S.C. § 77j

[176] 15 U.S.C. § 77j.

[177] 15 U.S.C. § 77b(a)(11).

[178] 15 U.S.C. § 77b(a)(11).

[179] 17 C.F.R. § 230.141.

usual and customary seller's commission, such person is not an underwriter.

4. If an investment bank purchases securities for resale from a controlling person, the investment bank is an underwriter and the registration process must be used.

5. It is not relevant how the controlling person acquired the securities (open market purchase, directly from the issuer or in a registered public offering); registration is required on resale unless an exemption is available.[180]

6. Non-controlling persons may sell unrestricted securities through a dealer without registration, since the dealer is not deemed to be an underwriter and is exempt in its capacity as a dealer pursuant to Section 4(3).[181]

IX. EXEMPT SECURITIES

A. Section 3[182] of the Securities Act exempts transactions in certain securities from registration.

1. It exempts securities issued or guaranteed by:

a) the U.S. Government and its agencies;

b) state and local governments; and

c) banks (not bank holding companies).

2. Section 3(a)(3)[183] exempts commercial paper arising out of current transactions with a maturity not exceeding 9 months.

3. Section 3(a)(6)[184] exempts certain railroad equipment trust certificates.

4. Section 3(a)(11)[185] exempts any security that is part of an issue offered and sold solely to persons in the state where the issuer is a resident, does its business and, in the case of a corporation, is incorporated. Rule 147[186] outlines requirements that satisfy the Section 3(a)(11) exemption.

a) Rule 147 provides an exemption from registration when the securities are being sold exclusively to people from a

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[180] 17 C.F.R. § 230.144.

[181] 15 U.S.C. § 77d(3).

[182] 15 U.S.C. § 77c.

[183] 15 U.S.C. § 77c(a)(3).

[184] 15 U.S.C. § 77c(a)(6).

[185] 15 U.S.C. § 77c(a)(11).

[186] 17 C.F.R. § 230.147.

single state or territory, and when the issuer of the Rule 147 securities is a resident of and does business in that same state or territory. In determining whether the issuer does business in such state or territory, three 80% tests are utilized.[187]

X. EXEMPT TRANSACTIONS

A. Section 4[188] of Securities Act exempts certain transactions from registration.

1. Section 4(1)[189] exempts all transactions by any person other than an issuer an underwriter or a dealer.

2. Section 4(2) exempts transactions by an issuer not involving any public offering.

a) No "general solicitation" is allowed, but a public company can make a public announcement under Rule 135(c).[190]

b) The securities are "restricted" for purposes of Rule 144.[191]

c) The "Section 4(1½) Exemption" relies on Section 4(1) and Section 4(2). It allows parties that have acquired restricted securities to resell these securities, but the securities retain their "restricted" status.

3. Section 4(3)[192] and Rule 174[193] exempt most dealer transactions from the prospectus delivery requirements of Section 5, other than:

a) Unsold allotments (i.e., the original securities which are still in the hands of an underwriter are being held for distribution rather than investment); and

b) Other sales occurring during the 25 or 90 days following an initial public offering.

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[187] 14 C.F.R. § 230.147(c)(2)(iii). All three of these tests must be satisfied: (1) the issuer derived at least 80% of its gross revenues and those of its subsidiaries on a consolidated based from such state or territory; (2) 80% of its assets and those of its subsidiaries on a consolidated basis are located in such state or territory; and (3) the issuer intends to use at least 80% of the net proceeds from the Rule 147 securities sale in connection with the operation of a business or real property, the purchase of real property located in, or the rendering of services within such state or territory. *Id.*

[188] 15 U.S.C. § 77d.

[189] 15 U.S.C. § 77d(1).

[190] 17 C.F.R. § 230.135(c).

[191] 17 C.F.R. § 230.144.

[192] 15 U.S.C. § 77d(3).

[193] 17 C.F.R. § 230.174.

4. A “dealer” includes any person who acts as an agent, broker or principal in the business of dealing or trading in securities issued by another person.[194]

5. Section 4(6)[195] exempts private placements of less than $5 million to “accredited investors.”

B. Regulation D[196] is a set of rules that allows the limited offer and sale of securities without registration under Section 5 of Securities Act.

1. Preliminary Notes

a) Preliminary Note 1 of Regulation D states that transactions under the rule “are not exempt from the anti-fraud, civil liability or other provisions of the Federal securities laws.”[197]

b) Issuers are reminded of their obligation to provide such further material information as may be necessary to ensure the information required under this regulation is not misleading, in light of the circumstances under which it is furnished.

2. Rule 502[198] - General conditions applicable to offers and sales made under Regulation D.

a) Rule 502(a) – Six Month Integration Safe Harbor[199]

(1) This rule applies to transactions exempt under Regulation D, but not necessarily those outside of the Regulation D context.

(2) Offers or sales that are made greater than 6 months before the start of a Regulation D offering, or are made greater than 6 months after the completion of a Regulation D offering, will not be considered part of a Regulation D offering so long as during that six month period there are no offers or sales of securities by or for the issuer that are the same as or a similar class as those offered or sold under Regulation D.

b) Rule 502(b) - Information requirements are extensive.[200] Generally, if one is to sell to non-accredited investors, a private placement memorandum meeting the requirements

[194] 15 U.S.C. § 77b(a)(12)).

[195] 15 U.S.C. § 77d(6).

[196] 17 C.F.R. §§ 230.501 – 508.

[197] 17 C.F.R. § 230.501.

[198] 17 C.F.R. § 230.502.

[199] 17 C.F.R. § 230.502(a).

[200] 17 C.F.R. § 230.502(b).

of applicable federal forms under Regulation S-K[201] must be provided.

(1) This information must be furnished at "a reasonable time prior to the sale of the securities."[202] The nature of the information varies based on whether the issuer is a public company, the amount of money being raised (with breakpoints at $2 million and 7.5 million), whether the transaction involves a business combination or exchange offer, whether the issuer is foreign or domestic, and the availability of required or pre-existing financial information.

(2) When an issuer provides information to non-accredited investors as described above, it should consider providing such information to accredited investors, as well, in view of the anti-fraud provisions of the federal securities laws. The failure to comply with this requirement appears to taint the offering from a state preemption perspective.

c) 502(c) – There are limitations on the manner of offering.[203] Neither the issuer, nor anyone acting on behalf of the issuer in a Rule 506[204] offering, shall offer or sell securities by any form of general advertising or solicitation. Rule 502(c) lists examples of promotional efforts that would violate that prohibition.[205].

d) 502(d) – There are limitations on resale of the securities.[206]Securities acquired in a transaction under Rule 506 have the status of those sold generally under Section 4(2) of the Securities Act. They cannot be resold without registration under the Securities Act or an exemption therefrom.

(1) Issuers must have a system to prevent redistribution immediately after the offering, and must enforce it.

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[201] 17 C.F.R. § 229.10 *et seq*.

[202] 17 C.F.R. § 230.502(b)(1).

[203] 17 C.F.R. § 230.502(c)

[204] 17 C.F.R. § 230.506.

[205] The issuer can violate this restriction in a variety of ways. For example, violations include talking with a reporter who runs a story about the offering, placing advertisements in local papers, or doing a mass mailing. Holding a seminar or meeting whose attendees have been invited by general advertising or solicitation would also likely violate the restriction. The general principle for issuers to follow is that no offers should be made to persons unknown to them or those affiliated with their placement agent.

[206] 17 C.F.R. § 230.502(d)

(2) Appropriate legends and disclosures must also be made to avoid preemption loss.

3. Regulation D Exemptions - Rule 504,[207] Rule 505[208] and Rule 506[209]

a) Size of offering:

(1) Rule 504 - $1 million.

(2) Rule 505 - $5 million.

(3) Rule 506 – No limit.

b) Manner of Offering:

(1) Rule 504 - General solicitation & advertising permitted only if: (1) offered in states that permit general solicitation under the state's registration exemption provision. General solicitation permitted prior to 4/7/99.

(2) Rule 505 - No general solicitation or advertising.

(3) Rule 506 – No general solicitation or advertising.

c) Number of Purchasers:

(1) Rule 504 - No restrictions.

(2) Rule 505 - Unlimited accredited investors; up to 35 non-accredited investors.

(3) Rule 506 – Unlimited accredited investors; up to 35 non-accredited investors.

d) Resale Restrictions:

(1) Rule 504 - Generally yes, but if conditions for the use of general solicitation are met, the securities are not restricted on resale.

(2) Rule 505 – Yes.

(3) Rule 506 – Yes.

e) Investor Qualification:

(1) Rule 504 – None specified.

(2) Rule 505 - None specified.

(3) Rule 506 - Non-accredited investors must be sufficiently knowledgeable & experienced in business

[207] 17 C.F.R. § 230.504.

[208] 17 C.F.R. § 230.505.

[209] 17 C.F.R. § 230.506.

and financial matters so as to be able to evaluate risks of investment.

f) Issuer Qualification:

(1) Rule 504 - No reporting companies, investment companies or certain development stage companies.

(2) Rule 505 - No investment companies; “bad boy” provisions.

(3) Rule 506 – None.

g) Information Requirements:

(1) Rule 504 – None specified.

(2) Rule 505 - Non-accredited investors must be provided specified financial and other information prior to sale depending on whether the issuer is a reporting company.

(3) Rule 506 - Non-accredited investors must be provided specified financial and other information prior to sale depending on whether the issuer is a reporting company.

h) Filing Requirements:

(1) Rule 504 - Form D no later than 15 days after first sale.

(2) Rule 505 - Form D no later than 15 days after first sale.

(3) Rule 506 - Form D no later than 15 days after first sale.

4. Notice Filings

a) The failure to make a notice filing with the SEC will not adversely affect the availability of preemption for the offering. Such a failure is a technical violation and the filing is not a condition of the federal exemption under Rule 506.

5. Disqualification

a) Rule 507[210] provides that no person can utilize Rule 506 if the issuer or its predecessors or affiliates have been subject to any order, judgment, or decree of any court of competent jurisdiction enjoining a failure to comply with Rule 503[211] (the notice filing requirements).

[210] 17 C.F.R. § 230.507.

[211] 17 C.F.R. § 230.503.

b) Prior to preemption through NSMIA,[212] the states had an extensive list of disqualifications from the use of Rule 506. Preemption stuck to those disqualifications, but not the need to disclose them to meet the anti-fraud provisions or the specific disclosure requirements of Rule 502(b) remains.

6. There is no preemption for Rule 504[213] or 505.[214]

7. Insignificant Deviations – Rule 508[215] provides that a failure to comply with Rule 506 will not result in the loss of the exemption from the registration requirements of Section 5[216] of Securities Act for any offer or sale to a particular individual or entity if certain conditions are met.

8. Resale of Restricted Securities and Sale of Securities by Control Persons

a) An owner of securities acquired in a private placement (restricted securities) or a control person owning securities of the issuer (however they were acquired) can dispose of such securities without registering them pursuant to Rule 144 if certain conditions are met:

(1) There must be certain publicly available information with respect to the issuer;

(2) Within any three months, a person (subject to aggregation rules) can sell the higher of 1% of the outstanding shares or the average weekly trading volume during the four preceding weeks;

(3) The securities must be sold in a brokers' transaction, in a transaction directly with a market maker, or in a riskless principal transaction where the offsetting trades must be executed at the same price, the transaction can be reported as riskless by the governing SRO's rules, and other requirements as to Rule 144 are met (and the person selling the securities shall not solicit orders or make any payments in connection with the sale other than to the broker executing the order);

(4) The minimum holding period is complied with;

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[212] National Securities Markets Improvement Act of 1996, Public Law No. 104-290, 110 Stat. 3416.

[213] 17 C.F.R. § 230.504.

[214] 17 C.F.R. § 230.505.

[215] 17 C.F.R. § 230.508.

[216] 15 U.S.C. § 77e.

(a) For restricted stock of issuers that have been subject to the reporting requirements of Section 13[217] or 15(d)[218] of the Exchange Act for a period of at least 90 days), the purchaser must hold the stock for six months before disposing of it; restricted stock of non-reporting issuers is subject to a one-year holding period requirement.[219]

(b) For control stock that is not also restricted stock, there is no holding period before the stock may be sold.

(c) An individual selling securities pursuant to Rule 144 must notify the SEC at the time the order is placed with the broker. The notice requirement applies to both restricted and control stock. Notice is not required if the amount of the sale does not exceed 5000 shares or the dollar amount does not exceed $50,000.

(5) If securities being sold pursuant to Rule 144 have not been sold within 90 days of the date that notice is filed with the SEC, an amended notice must be filed.

9. Form D

a) Federal and state regulators, along with SROs, use Form D filings for two primary purposes:

(1) To collect data for use in rulemaking efforts; and

(2) To enforce the federal and state securities laws and the rules of SROs, including enforcement of the exemptions in Regulation D.

b) Potential investors in Regulation D offerings may use Form D to check whether the company making the offering has filed a Form D notice. "If the company has not filed a Form D, this should alert . . . [the investor] that the company might not be in compliance with the federal securities laws."[220]

c) Recent Amendments to Form D:

[217] 15 U.S.C. § 78m.

[218] 15 U.S.C. § 78o(d).

[219] *See* Revisions to Rules 144 and 145, Securities Act Release No. 8869, 72 Fed. Reg. 71,545 (Dec. 17, 2007).

[220] Form D, SEC, http://www.sec.gov/answers/formd.htm.

(1) Amendments to address deficiencies in the Form D data collection requirements, and update the submission of the form.[221]

(2) Specifically, the amendments:

(a) Require Form D to be filed electronically after March 16, 2009 (voluntary after September 15, 2008);

(b) Mandate amendments to remedy material mistakes in prior filings, to update certain information and require an annual amendment for ongoing offerings;

(c) Eliminate the reporting of beneficial owners of the issuer in the Form;

(d) Revise Form D to disclose:

(i) First date of sale; and

(ii) 1940 Act exemption; and

(iii) Brokers and finders;

(e) Revise Form D to include an undertaking to provide offering materials to regulators.

C. Proposed Revisions of Regulation D: Proposed Rule 507[222] – Exemption for Limited Offers and Sales to Large Accredited Investors.

1. The SEC proposed to create a new exemption to the registration requirements of the Securities Act for offers and sales of securities to a new category of investors called "large accredited investors."

2. The exemption would permit limited advertising of these offerings. Large accredited investors would consist of the same categories of entities and individuals that qualify for accredited investor status under existing Rule 506, but with significantly higher dollar-amount thresholds for investors subject to such thresholds.

3. Legal entities that are considered accredited investors (their assets exceed $5 million) would be required to have $10 million in investments to qualify as large accredited investors.

4. Individuals generally would be required to own $2.5 million in investments or have annual income of $400,000 (or $600,000 with one's spouse) to qualify as large accredited investors, as compared

[221] *See* Electronic Filing and Revision of Form D, Securities Act Release No. 8891, Exchange Act Release No. 57280, Investment Company Act Release No. 28145, 73 Fed. Reg. 10,592 (Feb. 27, 2008).

[222] *See* Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8828, Investment Company Act Release No. 27922, 72 Fed. Reg. 45,116 (Aug. 3, 2007).

to the current accredited investor standard of $1 million in net worth or an annual income of $200,000 (or $300,000 with one's spouse).

5. Legal entities that are not subject to dollar-amount thresholds to qualify as accredited investors (generally government-regulated entities) would not be subject to dollar-amount thresholds to qualify as large accredited investors.

6. The proposal is patterned generally after the Model Accredited Investor Exemption adopted by the North American Securities Administrators Association ("NASAA") in 1997.

7. Like the Model Accredited Investor Exemption, the proposal does not eliminate the prohibition on general solicitation and general advertising from conditions of the exemption.

8. Both the Advisory Committee on Smaller Public Companies and the American Bar Association's Committee on Federal Regulation of Securities recommended relaxing the ban on general solicitation for transactions with purchasers who do not need the protection of registration.

9. The proposal attempts to ease restrictions on limited offerings of securities in a manner that is cognizant of the potential harm of offerings by unscrupulous issuers or promoters who might take advantage of more open solicitation and advertising to lure unsophisticated investors to make investments in exempt offerings that do not provide all the benefits of Securities Act registration.

10. The proposed Rule 507 exemption would share the following characteristics with the Rule 506 exemption:

   a) it would allow an issuer to sell an unlimited amount of its securities to an unlimited number of investors who meet specified criteria – accredited investors in the case of Rule 506 transactions and large accredited investors in the case of Rule 507 transactions;

   b) Its availability would focus on purchasers, and not depend on the characteristics of offerees;

   c) It would place no restrictions on the payment of commissions or similar transaction-related compensation;

   d) It would be non-exclusive, meaning that the issuer could choose to claim any other available exemption without the benefit of the rule;

   e) Securities acquired in a transaction under the rule would be subject to the limitations on resale under Rule 502(d) and therefore would be treated as "restricted securities" as defined in Securities Act Rule 144(a)(3)(ii);

f) The issuer would be required to exercise reasonable care to assure that the purchasers of the securities are not underwriters; and

g) The issuer would have an obligation to file a notice of sales in the offering with the SEC on Form D.

11. In addition, proposed Rule 507 would include the same disqualification provisions as proposed below for other Regulation D exemptions. Currently, Rule 506 has no bad actor disqualification provisions.

a) Rule 507 would differ from Rule 506 in five ways.

(1) Large Accredited Investor Standard - Rule 507 would be premised on the concept of large accredited investors. Rule 506 would continue to be premised on the concept of accredited investors.

(2) Limited Advertising Permitted - Instead of a total ban on general solicitation and general advertising, as is the case in Rule 506 transactions, issuers in Rule 507 transactions could engage in limited advertising that satisfies the requirements of the rule. All other general solicitation and advertising would be prohibited.

(3) No Sales to Persons Who Do Not Qualify as Large Accredited Investors - Issuers in Rule 507 transactions would not be allowed to sell securities to any investor who did not qualify as a large accredited investor. In Rule 506 transactions, issuers may sell securities to an unlimited number of accredited investors and up to 35 non-accredited investors.

(4) Authority for Exemption - Rule 507 would be adopted as an exemption primarily under the SEC's general exemptive authority under Section 28[223] of the Securities Act, while Rule 506 was adopted as a safe harbor under Section 4(2)[224] of the Securities Act.

(5) Covered Security Status - Securities sold in accordance with either of these rules would be considered "covered securities," but under different provisions of Section 18 of the Securities Act. Securities sold under Rule 507 would be covered securities because the purchasing large accredited

[223] 15 U.S.C. § 77z-3.

[224] 15 U.S.C. § 77d(2).

investors would be defined as "qualified purchasers" under Section 18(b)(3)[225] of the Securities Act. Securities sold under rule 506 would continue to be covered securities under Section 18(b)(4)(D)[226] of the Securities Act because Rule 506 was issued under Section 4(2) of the Securities Act.

D. Regulation S[227] provides non-exclusive safe harbors for (1) offers and sales by issuers, distributors and their affiliates and (2) resales by others. In general, in order to qualify:

1. There must be an "offshore transaction" (the sale cannot be made to a person in the U.S. - the buyer must be outside the U.S. or the seller must reasonably believe the buyer is outside the U.S.); and

2. Neither the issuer nor any distributor (or any affiliate of either) may engage in any "directed selling efforts" (activities that may condition the U.S. for the securities).

3. In addition, there is a distribution compliance period during which no offer or sale may be made to a U.S. person for 40 days or, in some instances, for one year. Offering documents and underwriting agreements must reflect certain restrictions on sales to U.S. persons.

a) Note: In 1998, the SEC adopted amendments to Regulation S, extending the distribution compliance period to one year for securities classified as "restricted securities".[228]

4. For such securities to be resold in U.S. or to U.S. persons without registration, the requirements of Rule 144 must be met, including the six month/one year holding period.[229]

XI. RESALE OF RESTRICTED SECURITIES AND SALE OF SECURITIES BY CONTROL PERSONS

A. An owner of securities acquired in a private placement or a control person owning securities of the issuer can dispose of such securities in the following six ways:

1. In a registered offering;

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[225] 15 U.S.C. § 77r(b)(3).

[226] 15 U.S.C. § 77r(b)(4)(D).

[227] 17 C.F.R. §§ 230.901 – 905.

[228] 17 C.F.R. § 230.144.

[229] *See* Revisions to Rules 144 and 145, Securities Act Release No. 8869, 72 Fed. Reg. 71,545 (Dec. 17, 2007).

2. In a further private placement (4(1½) exemption) - the Section 4(2) private placement exemption is by its terms available only to an issuer and not in connection with a resale;

3. To the public in a transaction not involving a “distribution,” as per Rule 144;

4. In the case of certain securities that are not publicly traded, to “qualified institutional buyers” (“QIBs”), who purchase for their own account (or that of another QIB) pursuant to Rule 144A;[230]

5. In an offshore transaction under the resale provisions of Regulation S; or

6. By non-affiliates after one year.

XII. RESALES OF RESTRICTED SECURITIES PURSUANT TO REVISED RULES 144 AND RULE 145

A. General

1. In 1972, the SEC adopted Rule 144 to provide a safe harbor from the definition of “underwriter” to assist security holders in determining whether the Section 4(1) exemption is available for the resale of securities.

2. Rule 144 defines persons deemed not to be engaged in a distribution and therefore deemed not to be “underwriters” under Section 4(1).

3. Rule 144 provides safe harbor for public resale of:

a) “Restricted securities” by anyone; and

b) “Control securities” (and any securities held) by “affiliates.”

4. Rule 144 is explicitly not an exclusive safe harbor, but is, for practical purposes, the only way affiliates can sell publicly without registration.

5. Rule 144 is not available if it is part of a ”scheme to evade” registration requirements.

6. On December 17, 2007, the SEC amended Rule 144 by, among other changes, shortening the holding period requirement for "restricted securities" of issuers that are subject to the reporting requirements of the Exchange Act. Additionally, the SEC amended Rule 145 of the Securities Act to eliminate the presumptive underwriter provision of Rule 145, except for transactions involving a shell company and revised the resale requirements in Rule 145(d).

B. Definitions Rule 144(a)

1. “Affiliate” of an issuer is any person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.

2. “Person” includes:

[230] 17 C.F.R. § 230.144A.

a) Any relative or spouse of such person, or any relative of such spouse, any one of whom has the same home as such person;

b) Any trust or estate in which such person or any of the relatives specified above collectively own 10% or more of the total beneficial interest or of which any of such persons serve as trustee, executor or in any similar capacity; or

c) Any corporation or other organization (other than the issuer) in which such person or any of the relatives specified above are the beneficial owners of 10% or more of any class of equity securities or 10% or more of the equity interest.

3. "Restricted Securities" means:

a) "Securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering;"

b) Securities subject to resale limitations under Regulation D, Regulation S or Rule 701; or

c) Securities acquired in a Rule 144A transaction, under Regulation CE or under Section 4(6).

d) Securities acquired in a rights offering under Rule 801 or exchange offering under Rule 802 with respect to or in exchange for restricted securities.

C. Sales of Restricted Securities By Non-Affiliates – Rule 144(b)(1)

1. General Rule for All Issuers: Any person who is not (and has not been for 3 months) an affiliate of the issuer may sell restricted securities under Rule 144 if the non-affiliate has held the securities for at least one year – with no other conditions or limitations.

2. Rule for Reporting Issuers. If the issuer is (and has been for 90 days) subject to the public reporting requirements of Section 13 or Section 15(d) of the Exchange Act (a "Reporting Issuer"), any person who is not (and has not been for 3 months) an affiliate of the issuer may sell restricted securities under Rule 144 if:

a) The non-affiliate has held the securities for at least 6 months; and

b) The issuer has filed all required reports (other than Form 8-K reports) during the 12 months preceding the sale (even if not timely filed).

D. Sales of Securities by Affiliates

1. Restricted Securities. Any person (or has been within the last 3 months) an affiliate of the issuer may sell restricted securities of the issuer under Rule 144 only if all of the following requirements have been met:

a) Current Public Information. Specified public information about the issuer must be publicly available. Rule 144(c).

b) Holding Period. A 6 month holding period is required for the restricted securities of a Reporting Issuer; a one year

holding period is required for restricted securities of a non-Reporting Issuer per Rule 144(d).

c) Volume Limitation. The amount of securities that can be sold in any rolling 3-month period is limited to the greater of (a) 1% of the outstanding securities or (b) the average weekly trading volume during the four calendar weeks before the order to execute the sale (subject to special rules for OTC Bulletin Board securities and debt and non-participating preferred securities) per Rule 144(e).

d) Manner of Sale. The securities must be sold in unsolicited "brokers' transactions," to "market makers" or in "riskless principal transactions" per Rule 144(f) and (g).

e) Notice of Sale. The seller must file a Form 144 at the time of the sell order if the seller intends to sell more than 5,000 shares (or units) or more than $50,000 worth of securities in any 3-month period per Rule 144(h).

2. Control Securities. Affiliates may sell non-restricted control securities of the issuer under Rule 144 if all of the above requirements other than the holding period have been met.

E. Current Public Information Requirement – Rule 144(c).

1. Reporting Issuers. If the issuer is (and has been for 90 days) immediately before the sale subject to the reporting requirements of Section 13 or Section 15(d) of the Exchange Act, it must have filed all required reports (other than Form 8-K reports) during the past 12 months preceding the sale (or for such shorter period that the issuer was required to file such reports) per Rule 144(c)(1).

a) Such reports need not have been timely filed.[231]

b) The seller can rely on a statement in the issuer's most recent quarterly or annual report that it has filed all required reports or a written statement from the issuer that it has complied with such reporting requirements, unless the seller knows or has reason to believe the issuer has not complied.

2. Non-Reporting Issuers. If the issuer is not subject to the reporting requirements of Section 13 or Section 15(d), there must be publicly available the information concerning the issuer specified in paragraphs (a)(5)(i) to (xiv) and (xvi) of Rule 15c-11(a)(5) per Rule 144(c)(2).

F. Holding Period Requirement – Rule 144(d)

1. General Rule

a) Reporting Issuers. At least 6 months must elapse between the later of the date of acquisition of the securities from the issuer, or from an affiliate of the issuer, and any resale of the securities.

[231] *See* SEC Compliance and Disclosure Interpretations, Q&A 107.02 (April 2, 2007).

b) Non-Reporting Issuers. At least one year must elapse between the later of the date of acquisition of the securities from the issuer, or from an affiliate of the issuer, and any resale of the securities.

c) Acquisitions from Affiliates. As noted above, an acquisition from an affiliate restarts the holding period. An acquisition from a non-affiliate does not; the purchaser may "tack" the non-affiliate's holding period.

d) Payment. The holding period does not begin until the full purchase price or other consideration has been paid.

e) Promissory Notes. A purchase by promissory note is not full payment unless it is (i) full recourse, (ii) fully secured by collateral other than the securities purchased, and (iii) paid in full prior to sale of the securities.

2. Special Rules – Rule 144(d)(3)

a) Stock Dividends, Splits, Etc. Securities acquired by stock dividend, split or recapitalization are deemed to have been acquired at the time the underlying securities were first acquired.

b) Conversions and Exchanges. Securities acquired from the issuer solely in exchange for other securities of the issuer are deemed to have been acquired at the time the surrendered securities were acquired, even if the securities surrendered were not convertible or exchangeable by their terms.

c) Contingent Issuances. Securities acquired as a contingent payment of the purchase price of a business are deemed to have been acquired at the time of the sale of the business, even if contingent on remaining employed or refraining from competition.

d) Pledged Securities. Securities acquired by a pledge, or by a purchaser, from an affiliate upon default under a pledge are deemed to have been acquired when they were acquired by the pledgor (unless pledged without recourse, in which case they are deemed acquired by the pledge at the time of the pledge or by the purchaser at the time of the purchase).

e) Gifts. Securities acquired from an affiliate by gift are deemed to have been acquired by the donee when they were acquired by the donor.

f) Trusts. Where a trust settlor is an affiliate of the issuer, securities acquired from the settlor by the trust, or acquired from the trust by the beneficiaries thereof, are deemed to have been acquired when they were acquired by the settlor.

g) Estates. Where a deceased person was an affiliate of the issuer, securities held by the affiliate's estate or acquired from the estate by its beneficiaries are deemed to have been

acquired when they were acquired by the deceased person – except that no holding period is required if the estate is not affiliate of the issuer or if the securities are s9old by a beneficiary who is not an affiliate of the issuer, but the public information requirements and notice of sale requirements do apply to any sale.

h) Rule 145(a) Transactions. The holding period for securities acquired in a Rule 145(a) transaction (merger or sale of assets where shareholder vote is required) is deemed to commence on the date the securities were acquired by the purchaser in such transaction (i.e., the holding period starts).

i) Holding Company Formation. Securities acquired in the formation of a holding company are deemed to have been acquired at the same time as the securities of the predecessor issuer where: (a) the holding company's securities are issued solely in exchange for the securities of the predecessor company; (b) holders receive securities of the same class evidencing the same proportional interest in the holding company as they had in the predecessor company, and the rights and interests are the same; and (c) immediately following the transaction, the holding company has no significant assets other than securities of the predecessor company.

j) Cashless Exercise of Options and Warrants. Securities acquired from the issuer solely upon cashless exercise of options and warrants will be deemed to have been acquired at the same time as the options or warrants, even if they did not originally provide for cashless exercise by their terms.

(1) If the options or warrants did not originally provide for cashless exercise and the holder provided consideration, other than securities of the same issuer, in connection with the amendment to permit cashless exercise, then the newly acquired securities are deemed to have been acquired at the time of the amendment so long as the exercise itself was cashless.

(2) If the options or warrants were not originally purchased for cash or property And do not create any investment risk to the holder (as with employee stock options), the newly acquired securities are deemed to have been acquired at the time the options or warrants are exercised so long as the full purchase price or other consideration is paid at that time.

3. Hedging and Short Sales

a) Tolling. In revising Rule 144, the SEC considered but did not include a provision tolling the holding period of a security holder maintaining a short position in, or any put or other option to dispose of, securities equivalent to the restricted securities owned by the security holder because it would unduly complicate Rule 144. The SEC stated that it would revisit the issue if it observes abuse related to hedging activities of holders of restricted securities.[232]

b) Short Sales. The SEC staff takes the position that, with respect to short sales in reliance on Rule 144 where the borrower closes out the short position using restricted securities, all the conditions of rule 144 must be met at the time of the short sale.[233]

G. Volume Limitations for Sales by Affiliates – Rule 144(e)

1. Equity Securities: The amount of equity securities (regardless of whether they are restricted) sold by an affiliate in any three month period shall not exceed the greater of:

a) 1% of the shares or other units of the class of securities outstanding as shown by the most recent report or statement published by the issuer; or

b) The average weekly trading volume in such securities reported on all national securities exchanges or automated quotation systems during the four calendar weeks preceding the filing of Form 144 notice (or if no notice is required, the date of the receipt of the order toe execute the sale by the broker or the date of execution of the sale to the market maker).

2. Debt Securities. The amount of debt securities or shares of non-participatory preferred stock (regardless of whether they are restricted) sold by an affiliate in any three month period shall not exceed the greater of the amount set forth in A above or 10% of the principal amount of the tranche of debt securities (or class of non-participatory preferred stock).

3. Determination of Amount

a) Convertible Securities. Where both convertible securities and securities of the class into which they are convertible are sold, the amount of the convertible securities sold is deemed to be the amount of securities of the class into which they are convertible for purposes of determining the aggregate amount of securities of both classes sold.

b) Aggregation of Sales by Pledgors and Pledgees. The amount of securities sold for the account of a pledge, or for the account of a purchaser of the pledged securities upon

[232] SEC Release 33-8869 at 26-27.

[233] SEC Release 33-8869 footnote 90.

default, during any three month period within six months (or within one year if the issuer is not a Reporting Issuer) after a default in the obligation secured by the pledge, and the amount of securities sold during the same three month period for the account of the pledgor shall not exceed, in the aggregate, the limitation set forth for equity and debt securities above, whichever is applicable. Note that sales by one pledge will not be aggregated with sales by other pledges of the same borrower unless they are acting in concert.

c) Aggregation of Sales by Donor and Donees. The amount of securities sold for the account of a donee during any three month period within six months (or within one year if the issuer is not a Reporting issuer) after the donation, and the amount of securities sold during the same three month period for the account of the donor shall not exceed, in the aggregate, the limitation set forth for equity and debt securities above, whichever is applicable.

d) Aggregation of Sales by Settlors and Trusts. Where securities were acquired by a trust from the settlor, the amount of securities sold for the account of the trust during any three month period within six months (or within one year if the issuer is not a Reporting issuer) after the acquisition of the securities by the trust, and the amount of securities sold during the same three month period for the account of the settlor shall not exceed, in the aggregate, the limitation set forth for equity and debt securities above, whichever is applicable.

e) Aggregation of Sales by Deceased and Estate. The amount of securities sold for the account of the estate of a deceased person, or the beneficiary of such estate, during any three month period and the amount of securities sold during the same three month period for the account of the deceased prior to his death shall not exceed, in the aggregate, the limitation set forth for equity and debt securities above, whichever is applicable, provided that no limitation on amount shall apply if the estate is not itself an affiliate of the issuer.

f) Aggregation by Persons Acting in Concert. When two or more affiliates or other persons agree to act in concert for the purpose of selling securities of an issuer, all securities of the same class sold for the account of such persons during g any three month period shall be aggregated for the purpose of determining the limitation on the amount of securities sold.

g) Sales Not Aggregated. The following Sales of securities are not included in determining the amount of securities that may be sold under Rule 144:

(1) Securities sold pursuant to a registration statement;

(2) Securities sold pursuant to regulation A;

(3) Securities sold pursuant to an exemption under Section 4 of the securities Act not involving a public offering; and

(4) Securities sold offshore pursuant to Regulation S.

H. Manner of Sale – Rule 144(f) and (g)

1. Permitted Manners of Sale. Sales of equity securities by affiliates under Rule 144 must be made in one of three manners:

a) Broker's Transactions. A transaction where the broker (a) does no more than execute the order to sell the securities as agent, (b) receives no more than the usual and customary broker's commission, (c) does not solicit customers' orders to buy the securities in anticipation of or in connection with the sale, and (d) after reasonable inquiry, is not aware of circumstances indicating that the seller is an underwriter with respect to the securities or that the transaction is part of a distribution of securities.

b) Transactions directly with a market maker are conducted as defined in Section 3(a)(38) of the Exchange Act.

c) Riskless Principal Transactions. A principal transaction where, after having received from a customer an order to sell, sells the security as principal to the market to satisfy the order to sell.

2. Not applicable to:

a) Estates and beneficiaries who are not Affiliates (securities sold for the account of the estate of a deceased affiliate or for the account of a beneficiary of such estate provided the estate or estate beneficiary is not an affiliate of the issuer); or

b) Debt securities (debt securities, including non-participatory preferred stock).

I. Notice of Proposed Sale – Rule 144(h)

1. Threshold. If the amount of the securities to be sold by an affiliate under Rule 144 in any three month period exceeds 5,000 shares or other units or has an aggregate sale price greater than $50,000, three copies of a notice on Form 144 must be filed with the SEC and one copy must be filed with the principal national securities exchange on which the securities are traded.

2. Timing. The Form 144 must be filed prior to or concurrently with either the placing with a broker of an order to sell or the execution of the sale with a market maker.

3. Intent. The person filing the form must have a bona fide intention to sell the securities referred to in the notice within a reasonable time after the filing of the notice.

J. Unavailability of Rule 144 for Shell Companies.

1. Unavailable for Shell Companies. Rule 144 is not available for the resale of securities initially issued by an issuer that has, or at any time has had:

a) No or nominal operations; and

b) Either (a) no or nominal assets, (b) assets consisting solely of cash and cash equivalents, or (c) assets consisting of any amount of cash and cash equivalents and nominal other assets.

2. Available for Former Shell Companies. Rule 144 will become available to an issuer that was previously a shell company and has ceased to be a shell company if it:

a) Is a Reporting Issuer and has filed all required reports (other than Form 8-K reports) during the 12 months preceding the sale (or for such shorter period that the issuer was required to file such reports); and

b) Has filed current “Form 10 information” with the SEC reflecting its status as an entity that is no longer a shell company at least one year before any sale under Rule 144.

K. Amendments to Rule 145

1. Rule 145 provides that exchanges of securities in connection with reclassifications of securities, mergers or consolidations or transfers of assets that are subject to shareholder vote constitutes sales of those securities.

2. Consequences

a) Unless an exemption from registration requirements is available, Rule 145 requires the registration of these sales.

b) Rule 145 transactions effected through a private placement or exemption under Regulation D are treated as new investment decisions and therefore the Rule 144 holding period restarts for securities received by the security holders of the acquired company.

3. Presumed Underwriters. Prior to the February 15, 2008, amendments to Rule 144, Rule 145(c) deemed persons (other than the issuer) who are parties to a registered Rule 145 transaction and their affiliates to be underwriters. Thus, affiliates of an acquired company in a merger or other rule 145 transaction, were not free to sell the securities they acquired in the transaction – even though the issuance to them in the transaction was registered under 1933 Act on Form S-4.

4. Permitted Resales under Old Rule 145. However, old rule 145(d) permitted the resale of registered securities received by affiliates of a party to a Rule 145 transaction, subject to conditions

similar in some respects to Rule 144. Recipients of registered shares who were not affiliates of either party were free to resell their shares without restriction.

5. Amendment of Rule 145. In connection with the amendment of Rule 144, the SEC amended Rule 145 to limit the presumed underwriter principle to affiliates of either party who receive registered securities in Rule 145 transactions involving a shell company. Thus, affiliates (as well as non-affiliates) of the acquired company who receive securities in a registered Rule 145 transaction that does not involve a shell company are free to resell the securities immediately without restriction.

6. Resales by Former Affiliates in a Transaction Involving a Shell Company. Under the amended Rule 145(d), if the issuer has ceased to be a shell company, has filed "Form 10 information" (which can be included in the registration statement for the rule 145 transaction), and is a Reporting Company that has filed all required reports (other than Form 8-K reports) during the 12 months preceding the sale (or for such shorter period that the issuer was required to file such reports), then the persons who are deemed underwriters by virtue of Rule 145(c) will be able to resell securities acquired in a registered Rule 145 transaction if they meet any of the following three conditions:

    a) Beginning 90 days after the acquisition of the securities, sales may be made in accordance with the current public information requirement of Rule 144(c), the volume limitations of Rule 144(e), and the manner of sale requirements of Rule 144(f) and (g);
    b) If the seller is not (and has not been for 3 months) an affiliate of the issuer, beginning 6 months after the acquisition of the securities, sales may be made if the issuer meets the current public information requirement of Rule 144(c) without other restrictions; or
    c) If the seller is not (and has not been for 3 months) an affiliate of the issuer, beginning one year after the acquisition of the securities, sales may be made without restriction.

7. Resales by Non-Affiliate Shareholders of Acquired Company. Presumably, consistent with the SEC's position under old Rule 145, former shareholders of the acquired company who were not affiliates of the acquired company or the acquiring issuer company (and are therefore not presumed underwriters) may resell the registered shares they receive in the Rule 145 transaction without restriction immediately upon receipt.

8. Resales of Securities Received in Section 3(a)(10) Transactions

    a) Prior to amendment of Rule 144, the SEC took the position in Staff legal bulletin No. 3 that securities issued in a Rule 145 transaction pursuant to the exemption provided by

Section 3(a)(10) of the Securities Act, would be treated under Rule 145(d) in the same manner as securities issued in a registered Rule 145 transaction, subject to the same resale provisions as provided under Rule 145(d).

b) Amendment of Staff Legal Bulletin No. 3. In footnote 192 of the SEC Release No. 33-8869 adopting the final rules amending Rules 144 and 145, the SEC noted that the staff intends to issue a revised Staff legal bulletin No. 3 to address the treatment of parties to a transaction and their affiliates that have acquired securities in a transaction exempt from registration pursuant to Section 3(a)(10). Presumably, the amendment will apply the same resale principles to such securities as provided in new Rule 145 discussed above.

XIII. RULE 144A[234]

A. Rule 144A under the Securities Act provides a non-exclusive safe harbor exemption from the registration and prospectus delivery requirements of Section 5[235] of the Securities Act for certain offers and sales of non-fungible securities to qualified institutional buyers (“QIBs”) by person other than an issuer. While Rule 144A does not cover offers and sales by the issuer, it can apply to sales by an affiliate of an issuer.

1. Where an offering of newly issued securities is being structured pursuant to Rule 144A, the issuer firsts sells the securities to an initial purchaser, typically a broker dealer. Like all sales of securities, this initial sale must find its own exemption from registration. This exemption typically is Section 4(2) (possibly, though not necessarily, in reliance on Regulation D) or Regulation S under the Securities Act.

2. Rule 144A provides that sales to QIBs in compliance with Rule 144A are not distributions, and that the seller is therefore not an underwriter within the meaning of Section 2(a)(11) of the Securities Act. If the seller is not a dealer, it can rely on the Section 4(1) exemption.[236] If the seller is a dealer, it can rely on the Section 4(3) exemption.[237]

B. No General Solicitation

1. There is no express prohibition of general solicitations in Rule 144A. However, if a dealer in an underwritten private offering were to engage in any activity constituting general solicitation or general

[234] 17 C.F.R. § 230.144A.

[235] 15 U.S.C. § 77e.

[236] 15 U.S.C. § 77d(1)

[237] 15 U.S.C. § 77d(3)

advertising in connection with resales made in reliance on Rule 144A, this activity could jeopardize the issuer's exemption for the initial offer and sale to the dealer. In addition, it could also call into question the dealer's ability to rely on Rule 144A, since the offering might be characterized as a "series of transactions that, although in technical compliance with . . . [Rule 144A], is part of a plan or scheme to evade the registration provisions of the [Securities] Act."[238]

a) Communications Limited to QIBs. Although general solicitation is not fully defined by SEC rules, the general view among practitioners is that if the distribution in the United States or information regarding a private offering (even, for that matter, a direct placement by the issuer that does not rely on Rule 144A) is restricted to QIBs, there should be no general solicitation as a result.

b) Research. Under Rule 139,[239] if certain requirements are met, a broker or dealer's distribution of a research report would not be considered an offer to sell or general solicitation in connection with a Rule 144A offering. However, unless the issuer meets the requirements of Rule 139, U.S. distribution of research reports during a Rule 144A/Regulation S offering must be monitored (through, for example, the use of restrictive legends and maintenance of records as to addressees) to ensure that there is no U.S. distribution of such materials, or that they are only distributed to QIBs. While these restrictions on distributions address Securities Act registration issues, they do not address liability, business and reputational risk issues. U.S. investment banks have increasingly ceased distributing such reports to QIBs in the United States.

c) Internet Roadshows. Starting in 1997, the SEC staff issued several no-action letters that allowed issuers and underwriters to put roadshow slides onto the Internet in registered transactions.[240] Many of these mechanics are also being applied to Rule 144A/Regulation S offerings[241] on the basis that this activity does not constitute a general solicitation or general advertising. As long as access to the slides is password protected, and the password is distributed only to QIBs, the analysis is straightforward. Similarly, live roadshows at which attendance is limited to QIBs are also

[238] *See* 17 C.F.R. § 230.144A (Preliminary Note 3).

[239] 17 C.F.R. § 230.139.

[240] *See* Net Roadshow, Inc., SEC No-Action Letter, 1998 WL 40252 (Jan. 30, 1998).

[241] *See* Net Roadshow, Inc., SEC No-Action Letter, 1998 WL 40252 (Jan. 30, 1998).

permitted. In December 2005, the SEC adopted amendments to rules relating to communications in connection with securities offerings that supersede its no-action positions for registered offerings.[242] The reforms do not propose to supersede no-action positions with respect to Rule 144A and Regulation S offerings.

C. Qualified Institutional Buyer ("QIB")

1. With the exceptions noted below, a QIB is (1) an institution (insurance company, pension fund, employee benefit plan, corporation etc.) that owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the QIB or (2) an entity all the equity owners of which are QIBs. Proprietary and managed accounts may be aggregated for purposes of computing the eligibility threshold. QIBs can be foreign or domestic entities. QIBs must be institutions, and cannot be individuals, or pools of individuals, no matter how wealthy or sophisticated.

2. The following instruments, whether or not constituting securities for purposes of the Securities Act, are excluded from the calculation of amounts of securities owned and invested on a discretionary basis: bank deposit notes and certificates of deposit; loan participations; repurchase agreements; securities owned but subject to a repurchase agreement; and currency, interest rate and commodity swaps.

3. A QIB may purchase under Rule 144A only for its own account or for the account of another QIB.[243] While managed accounts are included in the computation of the $100 million threshold, a QIB may not purchase under Rule 144A for any managed account that is not itself a QIB. This requirement can create difficulties for large investment advisors that allocate orders among sub-accounts when either the sub-account is not a QIB or the advisor is unwilling to provide a certificate covering each of its sub-accounts to which an allocation is made.

4. QIB Entities

a) broker dealers. A securities dealer registered under Section 15[244] of the Exchange Act is a QIB if it owns and invests on a discretionary basis at least $10 million in securities. Securities held in investment and trading accounts may be counted for this purpose, but unsold

[242] *See* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52056, Investment Company Act Release No. 26993, 70 Fed. Reg. 44,722 (Aug. 3, 2005).

[243] 17 C.F.R. § 230.144A(a)(1)(i).

[244] 15 U.S.C. § 78o.

underwriting allotments may not. Dealers acting in a riskless principal transaction do not need to qualify as a QIB, but the ultimate purchaser does need to qualify as a QIB.

b) Banks and Thrifts. A U.S. or foreign bank or thrift institution is a QIB only if, in addition to owning and managing $100 million in securities, it has an audited net worth of at least $25 million, as demonstrated in its most recent annual financial statements as of a date within 16 months, or, in the case of foreign purchasers, 18 months of the transaction.[245]

c) Investment Companies. An investment company registered under the Investment Company Act is a QIB if it is part of a family of investment companies that owns in the aggregate at least $100 million in securities (other than securities of issuers that are affiliated with the investment company or are part of such family of investment companies).[246] A "family of investment companies" is defined as any group of registered investment companies (other than a unit investment trust the only assets of which are shares of registered investment companies) that have the same or affiliated advisors (or, in the case of unit investment trusts, the same or affiliated depositors).[247] It does not include foreign investment companies; as a result, foreign investment companies cannot aggregate by family and must meet the $100 million test on a fund by fund basis.

d) Subsidiaries. Any entity, all of the equity owners of which are QIBs, acting for its own account or the accounts of other QIBs, is itself a QIB.

5. Determination of QIB Status: Reasonable Belief. Rule 144A provides four non-exclusive means for determining QIB status:[248]

a) The purchaser's most recent publicly available financial statements;

b) The most recent publicly available documents filed by the purchaser with a federal, state, local or foreign governmental agency or self-regulatory body;

c) The most recent information appearing in a recognized securities manual; or

[245] 17 C.F.R. § 230.144A(a)(1)(vi).

[246] Rule 144A(a)(1)(iv).

[247] 17 C.F.R. § 230.144A(a)(1)(iv).

[248] 17 C.F.R. § 230.144A(d)(1).

d) A certification by an executive officer of the purchaser specifying the amount of securities owned and invested on a discretionary basis by the purchaser as of the close of the purchaser's most recent fiscal year or a later specified date.

e) Any information described in the first three clauses above must be as of a date no earlier than 16 months or, in the case of a foreign purchaser, 18 months prior to the sale. Large broker dealers maintain internal lists of customers that are reasonably believed to be QIBs, which are based upon public information or running lists of QIB certificates. Some broker dealers rely on lists prepared by a third party. The SEC has approved such third party lists as a method for establishing a reasonable belief a prospective purchaser is a qualified institutional buyer provided (1) the information underlying the inclusion of the entity on the list of QIBs was as of a date within 16 months preceding the date of the sale of the securities in the case of a U.S. purchaser and within 18 months preceding such date of sale for a foreign purchaser and (2) the person relying on the certifications provided by a purchaser did not know, and was not reckless in not knowing, that such certifications were false, and circumstances did not exist giving such person reason to question the veracity of such certifications.[249] The SEC noted that its determination was based on the procedures for compiling and updating the QIB list, which included (1) the use of questionnaires (which comply with the certification requirements of Rule 144A(d)(I)(iv)[250]) to put an institution on the list along with the date the information in the questionnaire was provided and (2) the automatic deletion of an institution if the most recent questionnaire provided is as of a date more than 16 months old in the case of a domestic institution, or 18 months old in the case of a foreign institution.

D. Notice Requirement

1. The seller and any person acting on its behalf must take reasonable steps to ensure that the purchaser is aware that the seller is relying on the exemption from the Securities Act registration provided by Rule 144A. Rule 144A offering memoranda contain a cover page disclosure and a Notice to Investors or Transfer Restrictions section indicating, *inter alia*, that the securities are being sold in reliance on Rule 144A. However, since Rule 144A also provides an exemption for what might otherwise be an illegal

[249] *See Communicator Inc.,* SEC No-Action Letter, 2002 WL 31626913 (Sept. 20, 2002).

[250] 17 C.F.R. § 230.144A(d)(1)(iv).

offer, consider whether the notice should be given to the prospective purchaser at the time of the offer even if this is before the legended offering memorandum is delivered.

E. Fungibility

1. Rule 144A is available for both debt and equity securities. However, it is not available for transactions in securities of the same class as securities already listed on a national securities exchange or quoted on the Nasdaq Stock Market. Securities quoted in the pink sheets or in the FINRA's PORTAL Market system are not excluded. Securities issued by open-end investment companies and unit investment trusts are not covered by the rule.

2. Debt securities and preferred stock of different series generally will be viewed as different, non-fungible classes of securities for purposes of Rule 144A. Securities that are convertible into listed securities must have a conversion premium of at least 10% of the bond's conversion value or they will be treated as securities of the class into which they are converted or exchanged. Warrants are treated as securities of the same class as the underlying securities unless at the time of issuance they had a term of at least three years and an effective exercise premium of at least 10%.

F. Information Furnishing Requirement

1. Rule 144A(d)(4) sets forth a information requirements that must be satisfied by the issuer. There are three ways to satisfy the requirement.

a) If the issuer is subject to Section 13(a)[251] or Section 15(d)[252] of the Exchange Act.

b) The issuer is exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act, or, in the case of a foreign governmental issuer, is eligible to register securities under Schedule B of the Exchange Act.

c) A holder of the securities and any prospective purchaser of the securities designated by a holder has the right to obtain on request certain designated information from the issuer.

2. A non-reporting issuer that has chosen the Rule 144A Regulation S offering format at least in part in order to avoid becoming a reporting company, will be required to agree to provide the information required by Rule 144A(d)(4).[253] The information required is further described below.

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[251] 15 U.S.C. § 78m(a).

[252] 15 U.S.C. § 78o(d).

[253] 17 C.F.R. § 230.144A(d)(4).

3. Foreign private issuers may elect to claim an exemption under Rule 12g3-2(b).[254] The Rule allows foreign private issuers to submit to the SEC information required by the local regulators or exchanges, and to remain exempt from Section 12(g)[255] of the Exchange Act. The information is not deemed "filed" for purposes of the liability provisions of the Exchange Act. A foreign private issuer can voluntarily claim an exemption under Rule 12g3-2(b) even if it does not meet the thresholds set out in the rule.

4. Issuers to which the requirement applies.

a) Where an entity fully and unconditionally guarantees the debt securities of its wholly owned subsidiary, the information furnishing requirement of Rule 144A (1) will be satisfied if the guarantor is subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act or is exempt from reporting pursuant to Rule 12g3-2(b), and (2) may be satisfied by looking to information concerning the guarantor.[256]

b) Similarly, the information furnishing requirement of Rule 144A will be satisfied in the case of debt securities issued by an agency or instrumentality of a foreign government (as defined in Securities Act Rule 405[257]) which are eligible to use schedule B and are fully and unconditionally guaranteed by such foreign government.[258]

c) When two companies combine to create a new company, each of the two companies becomes a wholly owned subsidiary of the newly created company, and the financial statements of the newly formed company would be substantially the same as the two wholly owned subsidiaries combined. The newly formed company's financial information and publicly available information would satisfy each of the wholly owned subsidiaries' obligations under Rule 144(d)(4).[259]

d) In the case of mortgage-backed or similar securities, the servicer or other person having title to the underlying assets will be considered to be the issuer, and the information requirement will be interpreted to require basic material

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[254] 17 C.F.R. § 240.12g3-2(b).

[255] 15 U.S.C. § 78l(g).

[256] *See* British Aerospace PLC, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 79,465 (May 9, 1990).

[257] 17 C.F.R. § 230.405.

[258] *See* Rule 144A, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 79,464 (May 30, 1990).

[259] *See* ConocoPhillips, SEC No-Action Letter, 2002 WL 1998010 (Aug. 23, 2002).

information concerning the securities, the assets, and any credit enhancement.

5. Information Required To Be Furnished by Non-reporting Issuers.

a) The information required to be furnished by a non-reporting issuer consists of (1) a very brief statement of the nature of the issuer's business and the products and services that it offers, and (2) the issuer's most recent balance sheet, profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation. The financial statements provided should be audited to the extent reasonably available.[260]

b) The required information must be reasonably current. If the description of the issuer's business is as of a date within 12 months prior to the sale, the balance sheet is as of a date less than 16 months prior to the date of the sale, and the statements of profit and loss and retained earnings are for the 12 months preceding the date of the balance sheet, it will be deemed to be reasonably current. If the date of the balance sheet is six months or more prior to the date of the sale, interim profit and loss and retained earnings statements must be provided.[261] For a foreign private issuer, however, the required descriptive and financial information will be deemed reasonably current so long as it meets the timing requirements of the issuer's home country or principal trading markets.[262]

c) Rule 144A does not provide how the security holder's right to obtain the required information must be established. The right could be created in the terms of the security, by contract, or by operation of law or the rules of a self-regulatory organization. The practice that has developed provides for the right to be established in the purchase agreement between the issuer and the underwriter, as well as in the indenture or fiscal agency agreement in the case of debt securities. If the right is provided in the purchase agreement, it should be made clear that the right to obtain is for the benefit of any holder or any prospective holder designated by holder.

[260] 17 C.F.R. § 230.144A(d)(1)(i-iv).

[261] 17 C.F.R. § 230.144A(d)(4)(iii).

[262] 17 C.F.R. § 230.144A(d)(4)(ii)(c).

G. Concurrent Private Placements and Registered Offerings (Block Box Policy)

1. In 1990 and 1992, the Division of Corporation Finance issued two letters in which it outlined an important policy position regarding private and registered offerings conducted concurrently.[263] Under the so-called “Black Box policy,” an issuer conducting a registered offering may also conduct a private offering without the two offerings being integrated if offers and sales in the private offering are made only to QIBs and to no more than two or three large institutions that, while not QIBs, are accredited investors within the meaning of Rule 501. The eligibility requirements apply with regard to all offerees in the private offering, not just those who purchase securities. In addition, the private offering must be exempt from registration on a stand-alone basis. The Black Box policy was announced in the context of registered and private offerings conducted concurrently, but the policy is also relied upon in the context of registered and private offerings that are not conducted concurrently. In the adopting release for Rule 155,[264] the SEC expressly acknowledged the Black Box policy. Rule 155 provides a non-exclusive safe harbor from the integration of certain private and registered offerings.

H. Rule 144A Relationship with Issuer's Exemption

1. Availability of Issuer's Exemption

a) The fact that purchasers of securities from the issuer may purchase such securities with a view to reselling them in reliance on Rule 144A will not affect the issuer’s ability to avail itself of an exemption under Section 4(2)[265] from the registration requirements of the Securities Act. (Preliminary Note 7 to Rule 144A permits an issuer to sell to an initial purchaser in reliance on Section 4(2) or Regulation S even though the initial purchaser contemplates the immediate resale to QIBs in reliance on Rule 144A.)[266]

b) Section (e) of Rule 144A provides that offers and sales of securities pursuant to the rule shall be deemed not to affect the availability of any exemption or safe harbor relating to any previous or subsequent offer or sale of such securities by the issuer, or any prior or subsequent holder thereof.[267]

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[263] *See* Black Box, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 79,510 (June 26, 1990); Black Box, Inc., SEC No-Action Letter, 1992 WL 55818 (Feb. 28, 1992).

[264] Integration of Abandoned Offerings, Securities Act Release No. 7943, 66 Fed. Reg. 8887 (Feb. 5, 2001).

[265] *See* 17 C.F.R. § 230.144A (Preliminary Note 7).

[266] *See* 17 C.F.R. § 230.144A (Preliminary Note 7).

[267] 17 C.F.R. § 230.144A(e).

The implication is that neither the issuer nor the initial purchasers in a Rule 144A offering should be exposed to legal liability for subsequent non-complying resales of the security so long as their purchases and sales fit within Section 4(2), Regulation D, or Rule 144A, as applicable.

c) Similarly, preliminary Note 5 to Regulation S[268] (discussed below) states that the availability of the Regulation S safe harbor to offers and sales that occur outside of the United States will not be affected by the subsequent offer and sale of these securities into the United States or to U.S. persons during the distribution compliance period, as long as the subsequent offer and sale are made pursuant to registration or an exemption therefrom under the Securities Act. This permits a foreign private issuer to sell to an initial purchaser outside the United States in reliance on Regulation S, even though the initial purchaser contemplates the immediate resale to QIBs in reliance on Rule 144A.

2. Interaction with Regulation D[269]

a) Accredited Investors. The initial purchaser in a Rule 144A transaction is, in practice, always an accredited investor within the meaning of Rule 501.[270] Accordingly, the issuer generally will satisfy the requirements of Regulation D if it complies with the general conditions set forth in Rule 502(a), (c), and (d),[271] and makes the filing required by Rule 503.[272] In most Rule 144A offerings, however, the Form D is not filed with respect to the first leg of the offering: the sale from the issuer to the initial purchasers. This may be the case because all parties and their counsel are sufficiently comfortable that the Section 4(2) exemption is available, and that whatever additional protection Regulation D provides does not justify the relatively minor inconvenience of preparing and filing the Form D.

b) Integration. Under Rule 502(a), offers or sales of securities that are of the same or a similar class as those sold in reliance on Regulation D may be integrated with the Regulation D offering. Generally, any prior or subsequent offering registered under the Securities Act should not pose

[268] 17 C.F.R. § 230.901 (Preliminary Note 5).

[269] 17 C.F.R. §§ 230.501 – 508.

[270] 17 C.F.R. § 230.501(a).

[271] 17 C.F.R. § 230.502(a), (c), (d).

[272] 17 C.F.R. § 230.503.

any integration problem.[273] Similarly, the SEC has made clear that transactions otherwise meeting the requirements of Regulation D or Section 4(2) will not be integrated with simultaneous offerings being made outside the United States in compliance with Regulation S under the Securities Act. On the other hand, in the case of a continuous offering (e.g., a private offering of medium-term notes) or a series of private placements of the same or similar securities, care should be taken to insure that all sales comply with Regulation D or another available exemption.

c) Limitations on Resale.

(1) Rule 502(d) requires that the issuer "exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of [Section 2(a)(1l)] of the [Securities] Act."[274] A person who purchases securities from an issuer in a Regulation D offering and resells such securities in accordance with Rule 144A is not an underwriter as defined in Regulation D.[275] Accordingly, an issuer that obtains from the initial purchaser a contractual undertaking not to resell except in accordance with Rule 144A should thereby be deemed to have satisfied the "reasonable care requirement" of Rule 502(d).

(2) Although Rule 144A does not require that express resale limitations be imposed on QIBs that acquire securities from the initial purchaser in a Rule 144A sale, current practice in many transactions is to only permit QIBs to resell Rule 144A securities to other QIBs, or pursuant to Regulation S or Rule 144, if available. These transactions include equity transactions, global offerings relying on Regulation S and Rule 144A and in transactions involving American Depositary Receipts (ADRs) or Global Depositary Receipts (GDRs), In other cases, a catch-all provision permits resales so long as they are exempt from registration. Offerings of ADRs and GDRs raise additional concerns.

(3) The placement of a restrictive legend on the securities is recommended even though this may not

[273] *See, e.g.*, 17 C.F.R. § 230.152.

[274] 17 C.F.R. § 230.502(d).

[275] *See* Adoption of Rule 144A, Securities Act Release No. 6862, Exchange Act Release No. 27928, Investment Company Act Release 17452, 55 Fed. Reg. 17,933 (Apr. 30, 1990).

be strictly necessary in order to satisfy the requirements of Rule 502(d) in the context of a Rule 144A offering. The use of a restrictive legend may help to establish the issuer's exemption under Section 4(2) in the event that the safe harbor provided by Regulation D later proves to be unavailable. A restrictive legend stating, among other things, that the seller of the security may be relying on the exemption from registration provided by Rule 144A may assist subsequent sellers in demonstrating that they have complied with the notice requirement of Rule 144A. Most importantly, a restrictive legend helps to distinguish securities sold in an underwritten private offering from other securities of the same class. Preliminary Note 6 to Rule 144A confirms that securities acquired in a Rule 144A transaction are deemed to be restricted securities within the meaning of Rule 144(a)(3).[276] Clearly, there is a need to distinguish Rule 144A securities from unrestricted securities of the same class. (In a world of book-entry settlement, this is also done through the use of distinctive CUSIP numbers.) Rule 144A securities must also be distinguishable from other restricted securities of the same class that are not eligible for Rule 144A resale (e.g., because such other restricted securities were fungible when issued). These problems of identification and tracing are especially likely to arise with respect to securities issued upon conversion of Rule 144A convertible securities.

XIV. THE "SECTION 4(1½) EXEMPTION”

A. Long before the adoption of Rule 144A, market participants and their counsel, drawing upon the requirements of Regulation D and practices under Section 4(2),[277] created a set of procedures to permit limited resales of restricted securities without the benefit of a specific regulatory safe harbor. Commonly known as Section 4(1½),the procedures are really designed to permit sellers of securities to rely on Section 4(1)[278] to avoid underwriter status by implementing the same kinds of restrictions that would be required in the case of a Section 4(2) offering by the issuer itself. These procedures include: (1) non-distribution letters in which the purchaser agrees to contractual resale restrictions and makes certain representations and warranties as to its sophistication and investment

[276] 17 C.F.R. § 230.144(a)(3).

[277] 15 U.S.C. § 77d(2).

[278] 15 U.S.C. § 77d(1).

intent; (2) a legal opinion that no registration is required; (3) legended securities; (4) stop transfer instructions; and (5) large minimum denominations or investments. These restrictions will vary based upon the issuer, the nature of the investors, and the size of the offering.

B. Section 4(1½) is now used principally in four types of situations:

1. In secondary offerings, where the securities are not Rule 144A eligible:

2. In secondary offerings, where the issuer does not comply with the ongoing information requirements of Rule 144A(d)(4);

3. In primary, unregistered offerings of shares of foreign private issuers, where shares of the same class are already listed on the New York Stock Exchange or quoted on the Nasdaq Stock Market; and

4. In offerings to non-QIB institutional accredited investors side-by-side with a Rule 144A offering.

5. In the first three scenarios above, the unregistered offering is usually extended only to QIBs (but in principle need not be so limited), and is conducted much like a Rule 144A offering with one additional requirement. QIBs purchasing shares in the offering must sign investor representation letters in which they acknowledge the following:

a) They are QIBs;

b) The resale of the shares is restricted;

c) Rule 144A might not be available for re-sales; and

d) The shares cannot be deposited in an unrestricted American Depositary Receipts facility.

C. Depending on the level of U.S. trading volume, additional restrictions may be imposed, such as creating a second depositary facility or imposing more restrictive resale conditions.

D. Section 4(1½) is also sometimes used to extend a Rule 144A offering to institutional accredited investors. The term "institutional accredited investor" typically includes institutions that meet the requirements of subparagraphs (1), (2), (3) or (7) of Rule 501[279] and excludes wealthy individuals. Side-by-side offerings may also raise state blue-sky requirements that would not arise in offerings limited to QIBs.[280]

[279] 17 C.F.R. § 230.501.

[280] Offerings that involve individual investors can be expected to involve additional blue sky issues.

E. Whenever conducting a Section 4(1½) offering, participants must also consider whether Regulation M[281] under the Securities Exchange Act applies.

XV. RESALES PURSUANT TO SECTION 4(3)[282]

A. Dealers are required to comply with Section 5[283] and cannot rely on Section 4(1) as an exemption from Section 5. Dealers are defined to include brokers who are selling and buying for the account of others or their own account. Dealers, however, may rely on Section 4(3).

B. Section 4(3) exempts from compliance with Section 5 and the prospectus delivery requirement all dealers' transactions in securities in which a registration statement has been filed and which takes place more than 40 days (or in some instances 90 days) after the effective date of the registration statement, or the security is bona fide offered to the public.[284]

XVI. REGULATION S[285]

A. Territorial Approach - General Statement

1. The General Statement in Rule 901 of Regulation S[286] provides simply that the registration requirements of the Securities Act apply only to offers and sales of securities made in the United States and not to offshore transactions. This territorial approach holds that the applicability of Section 5 is limited to the protection of investors, whether they be U.S. or foreign nationals, who participate in the U.S. capital markets and, conversely, that investors who choose to rely upon capital markets located outside the United States are entitled only to the protections afforded by the local laws and regulations that govern those markets.

2. The general statement does not often serve as a basis for planning securities offerings; rather, to ensure availability of the exemption from registration, issuers, distributors and other sellers of securities outside the United States generally structure transactions to comply with one of the two Regulation S safe harbor provisions.

3. Safe Harbors

a) Regulation S includes two non-exclusive safe harbor provisions under which certain transactions will be deemed to occur outside the United States and, therefore, will not be

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[281] 17 C.F.R. §§ 240.100 – 105.

[282] 15 U.S.C. § 77d(3).

[283] 15 U.S.C. § 77e.

[284] 15 U.S.C. § 77d(3).

[285] 17 C.F.R. §§ 230.901 – 905.

[286] 17 C.F.R. §§ 230.901 – 905.

subject to the registration requirements of Section 5 of the Securities Act. The "Issuer Safe Harbor" (Rule 903)[287] applies to offers and sales by issuers, distributors, their respective affiliates and persons acting on their behalf. The "Resale Safe Harbor" (Rule 904)[288] applies to resales by persons other than the issuer, a distributor, their respective affiliates, and persons acting on their behalf. The term "distributor" is defined in Rule 902(c) as "any underwriter, dealer, or other person who participates, pursuant to a contractual agreement, in the distribution of the securities offered or sold in reliance upon Regulation S."[289]

4. General Conditions

a) Two general conditions must be satisfied in order for either the issuer safe harbor or the resale safe harbor to apply: (1) any offer or sale must be made in an offshore transaction; and (2) no directed selling efforts may be made in the United States in connection with any such offer or sale.[290]

(1) Offshore Transaction. An "offshore transaction" is a transaction in which (1) the offer is not made to a person in the United States and (2) either (a) at the time the buy order is originated, the buyer is outside the United States (or the seller and any person acting on its behalf reasonably believe that the buyer is outside the United States) or (b) for purposes of the issuer safe harbor, the transaction is executed in, on or through a physical trading floor of an established foreign securities exchange or, for purposes of the resale safe harbor, the transaction is executed in, on or through the facilities of a designated offshore securities market, and neither the seller, nor any person acting on its behalf, knows that the transaction has been prearranged with a buyer in the United States.

(a) Offer Made Outside the United States. An offer is deemed to be made to a person outside the United States if the offeree is physically located outside the United States. Offers and sales specifically targeted at identifiable groups

[287] 17 C.F.R. § 230.903.

[288] 17 C.F.R. § 230.904.

[289] 17 C.F.R. § 230.902(c).

[290] 17 C.F.R. § 230.902(h).

of U.S. citizens abroad, however, will be deemed not to be made in offshore transactions. On the other hand, offers and sales made to certain professional fiduciaries acting for offshore and multinational organizations that, although located in the United States, are deemed not to be U.S. persons, are considered to be offers and sales made in offshore transactions.

(b) Buy Order Originated Outside the United States. Where the offer is not made to a person in the United States and, at the time the buy order is originated, the buyer is physically outside the United States, both the offer and the sale will satisfy the offshore transaction test, even if the buyer is a U.S. person (e.g., a U.S. resident, or a corporation or partnership organized in the United States) and even if the securities are paid for and delivered in the United States.

(c) Transactions Executed on Certain Offshore Securities Markets. The offshore transaction test may be satisfied without regard to the location of the person originating the buy order if the transaction is executed in, on or through the facilities of certain offshore securities markets. Generally, the transaction must be executed outside the United States, under the auspices and supervision of such offshore securities market, by or through a member of such market, or any other person authorized to effect such sales.

b) No Directed Selling Efforts. Neither the issuer safe harbor nor the resale safe harbor will be available to a seller of securities if any directed selling efforts are made in the United States. Directed selling efforts include any activities undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market for any of the securities being offered in reliance on Regulation S. Examples of selling activities that are specifically prohibited are:

(1) Mailing offering materials to non-QIB investors in the United States;

(2) Conducting promotional seminars in the United States (other than road shows that include QIBs only);

(3) Placing advertisements with radio or television stations broadcasting into the United States;

(4) Placing advertisements in publications with a "general circulation in the United States;" or

(5) Research not in compliance with Rule 139 or other types of research directed at non-QIBs in the United States.

(6) Generally, as stated above, research that complies with Rule 139[291] is not considered a general solicitation for purposes of Rule 144A or directed selling efforts for purposes of Regulation S. In the case of the issuer safe harbor, directed selling efforts made by the issuer, any distributor, any of their respective affiliates, or any person acting on their behalf will preclude reliance on the issuer safe harbor by any seller, whether or not that seller participates in the directed selling efforts. In addition, for the purpose of the issuer safe harbor, directed selling efforts may not be made at any time while a distribution is in progress and, where the availability of the safe harbor is conditioned on the adoption of transactional restrictions (see discussion below under the Issuer Safe Harbor), during the applicable restricted period as well.

(7) “Publications with a general circulation in the United States" are defined to include all publications printed primarily for distribution in the United States or that, during the preceding 12 months, have had an average circulation in the United States of 15,000 copies or more per issue. Where a publication produces a separate U.S. edition with a general circulation in the United States and one or more non-U.S. editions (e.g., the Financial Times), the U.S. edition may be disregarded in determining whether the non-U.S. editions, collectively, will be considered a publication with a general circulation in the United States.

c) Permitted Communications.

(1) Legal Notices. Any legal notice or other advertisement required to be published by foreign or U.S. law or the rules or regulations of a foreign or U.S. regulatory or self regulatory authority (such as a

[291] 17 C.F.R. § 230.139.

stock exchange) will be deemed not to be a directed selling effort, provided that the advertisement contains no more information than legally required and includes the restrictive language prescribed in the rule.

(2) Tombstone Advertisements. Certain tombstone advertisements appearing in a publication having less than 20% of its circulation in the United States are permitted. In calculating this percentage, the circulation of a publication's U.S. and comparable non-U.S. editions may be aggregated. The scope of the information permitted to be included in a tombstone advertisement is now (post Securities Offering Reform[292]) narrower than what would be permitted for advertisements made in compliance with Securities Act Rule 134.[293] Tombstone advertisements appearing in the United States as a matter of record only after the transaction is all sold and following the applicable distribution compliance period are permissible.

(3) Routine Corporate Communications. The restriction on directed selling efforts is not intended to prohibit routine commercial advertising or corporate communications for purposes unrelated to the offer or sale of securities by the issuer. Routine information is of a type normally published by the company and should be distributed only through channels regularly used by that company for the dissemination of that type of information.

(4) Safe Harbor for Announcements of Offshore Offerings. Announcements of offshore offerings in compliance with Rule 135,[294] Rule 135c,[295] or Rule 135e,[296] also do not constitute directed selling efforts under Regulation S.

d) Other Permitted Activities.

(1) Sales activities directed towards non-U.S. persons (as defined), including those directed towards

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[292] *See* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52056, Investment Company Act Release No. 26993, 70 Fed. Reg. 44,722 (Aug. 3, 2005).

[293] 17 C.F.R. § 230.134.

[294] 17 C.F.R. § 230.135.

[295] 17 C.F.R. § 230.135(c).

[296] 17 C.F.R. § 230.135(e).

professional fiduciaries and multinational organizations that, although located in the United States, are deemed not to be U.S. persons, are permitted.

(2) Bona fide site visits by prospective investors to real estate, plants, or other facilities located in the United States are permitted in connection with an offshore offering of securities.

(3) Securities professionals participating in a distribution may continue to publish in the normal course of business information, opinions, or recommendations concerning any issuer that is a reporting issuer under the Exchange Act, or any class of its securities, subject to the conditions in Rule 138[297] or 139 under the Securities Act.

(4) Under certain circumstances, Regulation S also contains a special exclusion for the distribution in the United States of a foreign broker dealer's quotations by a third-party system that distributes such quotations primarily in foreign countries.

e) Access by Journalists to Offshore Press Conferences of Foreign Issuers (Rule 135e).[298] Access by journalists for publications with a general circulation in the United States to offshore press conferences, press releases, and meetings in which a foreign private issuer or foreign government (but not a U.S. domestic issuer) discusses an offering outside the United States need not be limited where the information is made available to the foreign and the U.S. press generally and is not intended to induce purchases of securities by U.S. persons.

B. Issuer Safe Harbor - Rule 903[299]

1. For purposes of the issuer safe harbor, Regulation S distinguishes among three categories of securities.

2. Category 1 Securities. Category 1 includes (1) securities of foreign issuers as to which there is no substantial U.S. market interest, (2) all securities of foreign issuers, and certain securities of domestic issuers, that are offered and sold in overseas directed offerings, (3) securities backed by the full faith and credit of a foreign government, and (4) securities of both foreign issuers and domestic issuers offered and sold to employees of the issuer and

[297] 17 C.F.R. § 230.138.

[298] 17 C.F.R. § 230.135(e).

[299] 17 C.F.R. § 230.903.

its affiliates, pursuant to certain employee benefit plans established under foreign law.[300]

a) Substantial U.S. Market Interest. If a foreign issuer is selling equity, the issuer must reasonably believe at the commencement of the offering that there is no substantial U.S. market interest in the particular class of equity securities to be offered or sold. If a foreign issuer is selling debt, the issuer must reasonably believe at the commencement of the offering that there is no substantial U.S. market interest in its debt securities generally.

(1) Equity Securities. Substantial U.S. market interest in a class of equity securities exists whenever (1) the securities exchanges and inter-dealer quotation systems in the United States, in the aggregate, constitute the single largest market for such class of securities in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation, or (2) during such period, 20% or more of all trading in such class of securities took place through U.S. securities exchanges, and less than 55% of such trading took place through the securities markets of a single foreign country.

(2) Debt Securities. Substantial U.S. market interest exists with respect to a foreign issuer's debt securities if (1) the issuer's debt securities, its non-participating preferred stock and certain of its asset-backed securities are held of record by at least 300 U.S. persons, (2) in the aggregate, $1 billion or more in principal amount of its debt securities is held of record by U.S. persons, and (3) in the aggregate, 20% or more in principal amount of the issuer's debt securities is held of record by U.S. persons. In determining whether substantial U.S. market interest exists in an issuer's debt securities, commercial paper and similar obligations exempt under Section 3(a)(3)[301] of the Securities Act are excluded. Because a number of foreign private issuers have outstanding debt securities in bearer form making it impossible to apply these tests, it may be necessary as a prudential matter to treat foreign private issuers with large amounts of bearer debt as having substantial U.S. market interest, moving them to Category 2.

[300] 17 C.F.R. § 230.903(b)(1)(3).

[301] 17 C.F.R. § 230.902(a).

(3) Warrants and Convertible Securities. Substantial U.S. market interest in warrants is measured by the level of market interest in the securities to be acquired upon their exercise. Substantial U.S. market interest in a convertible security will be deemed to exist if such interest exists with respect to either the convertible security or the security into which it may be converted.

b) Overseas Directed Offerings.

(1) By Non-U.S. Issuer. A foreign issuer makes an overseas directed offering when the offering is directed into a single country other than the United States to residents thereof, and is made in accordance with the local laws and customary practices and documentation of such country.

(2) By U.S. Issuer. A domestic issuer may make an overseas directed offering of straight debt securities denominated in a foreign currency that are, neither convertible into U.S. dollar-denominated securities nor linked to U.S. dollars in a manner that in effect converts the securities to U.S. dollar-denominated securities. An overseas directed offering by a domestic issuer also must be directed into a single foreign country to residents thereof and be made in accordance with local laws and customs.

c) Foreign Governmental Issuers. Securities backed by the full faith and credit of a foreign government are also included in Category 1. A "foreign government" is defined to include the government of any foreign country or of any political subdivision of a foreign country.

d) Employee Benefit Plans. Category 1 also includes securities offered by a domestic or foreign issuer to its employees, or those of its affiliates, pursuant to an employee benefit plan established and administered in accordance with the laws of a foreign country and the customary practices and documentation of such country, provided that certain conditions are met.

3. Category 2 Securities. Category 2 includes all securities that are not eligible for Category 1 that are equity securities of a reporting foreign issuer, debt securities of a reporting issuer, or debt securities of a non-reporting foreign issuer with substantial U.S. market interest.[302]

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[302] 17 C.F.R. § 230.903(b)(2).

a) A "reporting issuer" refers to an issuer that (1) is required to file reports under the Exchange Act as a result of listing on a national securities exchange, registration of equity securities under Section 12(g) of the Exchange Act,[303] or registration of securities under the Securities Act, and (2) has filed all material required to be filed for the 12 months preceding the offering. It does not include a foreign issuer that has claimed an exemption from the registration requirements of Section 12(g) by furnishing materials to the SEC in accordance with Rule 12g3-2(b).[304]

b) In the case of Category 2 securities, general conditions of offshore transaction requirements and the prohibition on directed selling efforts apply in addition to the offering restrictions and transactional restrictions described below:

(1) Offering Restrictions. Each distributor must agree in writing that all offers and sales made during the applicable distribution compliance period will be made in accordance with the safe harbor provisions of Regulation S, or pursuant to registration under the Securities Act, or pursuant to another available exemption from the registration requirements of the Securities Act.

(a) The offering restrictions also require that all offering materials used during the distribution compliance period include restrictive language. The restrictive language must appear (1) in summary form, on the cover or inside front cover of any offering memorandum, (2) in the underwriting Section of any offering memorandum, and (3) in summary form, in any advertisement.

(b) The distribution compliance period for Category 2 is 40 days from the later of the date on which the securities were first offered to persons other than the distributors or the closing date.

(2) Transactional Restrictions.

(a) The securities may not be offered or sold to or for the benefit or account of any U.S. person (other than a distributor) prior to the expiration of the 40-day distribution compliance period.

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[303] 15 U.S.C. § 78l(g).

[304] 17 C.F.R. § 240.12g3-2(b).

Offers and sales by a distributor of an unsold allotment or subscription are deemed to be made during the distribution compliance period, regardless of when such offers and sales are actually made. However, once a distributor sells an allotment after the distribution compliance period to a non-U.S. person, the security restriction ceases immediately.

(b) Each distributor selling securities to another distributor, dealer or any person receiving a selling concession, fee, or other remuneration in respect of the securities sold, prior to the expiration of the 40-day distribution compliance period, must send a confirmation or other notice to such purchaser stating that the purchaser is also subject to the transactional restrictions. After the expiration of the distribution compliance period, securities not constituting part of a distributor's unsold allotment may be sold freely.

(3) Definition of U.S. Person. Generally, a "U.S. person" is defined to include individuals resident in the United States, irrespective of nationality, and partnerships or corporations organized or incorporated under U.S. law. A branch or agency of a foreign entity located in the United States is deemed to be a U.S. person.

(a) A discretionary or similar account (other than an estate or trust) will not be considered a U.S. person if it is held for the benefit of an account of a non-U.S. person by a dealer or other professional fiduciary even if the dealer or fiduciary is a U.S. person.

(b) A non-discretionary account will continue to be treated as a U.S. person if it is held for the benefit or account of a U.S. person, or as a non-U.S. person if it is held for the benefit or account of a non-U.S. person.

(c) Branches and agencies of U.S. banks and insurance companies located abroad are non-U.S. persons, provided that they operate for valid business reasons, are engaged in the banking or insurance business, and are subject to substantive local banking or insurance

regulation. Foreign branches and agencies of other U.S. business organizations will continue to be treated as U.S. persons.

4. Category 3 Securities. Category 3 is the residual category consisting of all securities that do not fall within Category 1 or Category 2.[305]

a) In effect, Category 3 covers:

(1) All securities of non-reporting domestic issuers;

(2) Equity securities of non-reporting foreign private issuers with substantial U.S. market interest; and

(3) Equity securities of reporting domestic issuers.

b) Offering Restrictions. The offering restrictions that must be implemented for a Category 3 offering are the same as those that must be implemented for a Category 2 offering, except that the applicable distribution compliance period in the case of Category 3 equity securities is one year rather than 40 days. Furthermore, Category 3 equity securities are restricted securities within the meaning of Rule 144.[306]

c) Transactional Restrictions.

(1) Debt Securities. The distribution compliance period for Category 3 debt securities is 40 days. Debt securities must be represented upon issuance by a temporary global security, which may be exchanged for definitive securities only upon expiration of the 40-day distribution compliance period, and for persons other than distributors, only against certification that the beneficial owner is a non-U.S. person or a U.S. person that purchased the securities in a transaction that did not require registration under the Securities Act (such as a QIB that purchased the securities in a sale made pursuant to Rule 144A).

(a) In addition, distributors that sell securities to other dealers during the 40-day distribution compliance period are required to deliver a notice stating that the purchaser is subject to the same restrictions on offers and sales as a distributor.

[305] 17 C.F.R. § 230.903.

[306] 17 C.F.R. § 230.144A.

(2) Equity Securities. The applicable distribution compliance period for Category 3 equity securities is one year.

(a) Each purchaser of the securities (other than a distributor) must:

(i) Certify that he is not (1) a U.S. person and is not acquiring the securities for the account or benefit of any U.S. person or (b) if such person is a U.S. person, that he purchased the securities in a transaction that did not require registration under the Securities Act;

(ii) Agree to resell such securities only in accordance with Regulation S or pursuant to registration or an available exemption under the Securities Act; and

(iii) Agree not to engage in hedging transactions with respect to such securities, unless in compliance with the Securities Act.

(b) Equity securities of a domestic issuer must contain a legend to the effect that transfer is prohibited except in accordance with Regulation S or pursuant to registration under the Securities Act, or an available exemption from registration, and that hedging transactions with respect to such securities may not be conducted unless in compliance with the Securities Act. In addition, the issuer must be required, either by contract or a provision in its bylaws, articles, charter, or comparable document, to refuse to register any transfer not made in accordance with Regulation S, or pursuant to registration under the Securities Act or an available exemption from registration. If, however, the securities are in bearer form or foreign law prevents the restriction on transfer, other reasonable procedures (such as a restrictive legend) must be implemented to prevent any transfer not made in accordance with Regulation S.

(c) In addition, distributors that sell securities to other dealers during the one-year distribution

compliance period are required to deliver a notice stating that the purchaser is subject to the same restriction on offers and sales as applies to the distributor.

(3) Convertible Securities of U.S. Reporting Issuers. Convertible securities of U.S. reporting companies that are Rule 144A eligible may be offered and resold pursuant to Regulation S without implementing the stop-transfer restrictions set out in Rule 903(b)(3)(iii)(4),[307] provided that:

(a) The convertible securities are held in global certificate form by a depository for a book-entry clearance facility;

(b) The convertible securities are identified by their CUSIP number[308] as restricted (thereby notifying persons trading the securities that transfers of the securities to U.S. purchasers are restricted);

(c) Information provided to publicly-available databases (e.g., Bloomberg) about the terms of the security must include a statement that the securities are subject to restrictions under Rule 144A and/or Regulation S;

(d) The offering memorandum used in the Regulation S offering of the convertible securities contains both deemed representations by purchasers that they are a non-U.S. person or QIB and the agreements regarding restrictions on resale and hedging required by Regulation S; and

(e) Any certificated securities (including both global and physical certificate securities) issued prior to the expiration of the distribution compliance period will bear a restrictive legend, and securities issued after the one year period will bear a restrictive legend as required by Rule 144. (Any definitive securities

[307] 17 C.F.R. § 230.903(b)(3)(iii)(4).

[308] CUSIP stands for Committee on Uniform Securities Identification Procedures. A CUSIP number identifies most securities, including: stocks of all registered U.S. and Canadian companies, and U.S. government and municipal bonds. The CUSIP system—owned by the American Bankers Association and operated by Standard & Poor's—facilitates the clearing and settlement process of securities. *See* CUSIP Global Services, www.cusip.com.

issued pursuant to Regulation S during the distribution compliance period must satisfy all of the requirements of Category 3, including the legending and certification requirements.)

d) Measurement of the Distribution Compliance Period. The distribution compliance period commences on the closing date of the offering or, if later, the date on which the securities are first offered to persons other than distributors in reliance on Regulation S, and ends 40 days thereafter (for Category 2 issuers and debt securities of Category 3 issuers) or one year thereafter (for equity securities of Category 3 issuers).[309]

(1) Continuous Offerings. When the securities are being offered in a continuous offering, the distribution compliance period commences upon the completion of the distribution (i.e., the last sale out of the allotment), as certified by the managing underwriter. In a continuous offering of non-convertible debt securities offered and sold in identifiable tranches (e.g., MTN programs), the distribution compliance period commences upon completion of the distribution of the tranche, as certified by the managing underwriter.

(2) Warrants. The underlying securities are deemed to be subject to a continuing distribution so long as the warrants are outstanding. The category of the offering of the warrants is determined by reference to the underlying securities. The distribution compliance period for both the warrants and the underlying securities commences upon the completion of the distribution of the warrants, as certified by the managing underwriter, provided certain additional requirements (including a certification requirement) designed to restrict exercise of the warrants by U.S. persons are satisfied.

(3) Convertible Securities. For purposes of applying the distribution compliance periods under the issuer safe harbor, a convertible security generally is treated as the security into which it is convertible, and the applicable distribution compliance period for both the convertible security and the underlying security generally commences upon the closing date of the

[309] *See* Sale of Convertible Securities of U.S. Reporting Companies under Regulation S, SEC No-Action Letter, 1998 WL 546673 (Aug. 26, 1998).

offering of the convertible security (or, if later, the date on which the convertible security was first offered to persons other than distributors in reliance on Regulation S). Where an exempt conversion under Section 3(a)(9) of the Securities Act[310] occurs during the restricted period, the security issued upon conversion will be restricted for the remainder of the restricted period. Where the conversion of the convertible security is not exempt under Section 3(a)(9), however, the convertible security will be treated in the same manner as a warrant.

(4) American Depositary Shares. Regulation S does not contain any reference to the treatment of sales of ADSs during a distribution compliance period applicable to securities of the same class as those deposited against issuance of the ADSs. In analyzing such situations, however, the SEC will focus on the sale of ADSs by the depositary (i.e., the delivery of ADSs against the deposit of underlying securities). The issuance of ADSs in exchange for previously deposited securities, and the withdrawal of underlying securities by ADS holders during a distribution compliance period are not precluded. The issuance of ADSs against new deposits is permitted if (1) the deposited securities are received by the depositary prior to the commencement of the offshore distribution or (2) the depositary determines by examination of the certificate or otherwise that the security to be deposited is not subject to the selling restrictions and is neither borrowed nor deposited with the intention that it be replaced with securities subject to selling restrictions.

C. Resale Safe Harbor - Rule 904[311]

1. The resale safe harbor is available to any person other than an issuer, a distributor, or any of their respective affiliates (other than an officer or director who is an affiliate solely by virtue of holding such position).

2. A distributor and its affiliates may rely on the resale safe harbor in connection with secondary transactions in other securities of the same class as those being distributed, provided the securities are not borrowed or replaced with securities from a distribution. Once the distribution has been completed (the securities are all sold) and

[310] 17 C.F.R. § 230.903(b)(3).

[311] 17 C.F.R. § 230.904.

any applicable distribution compliance period has expired, a distributor will cease to be a distributor for purposes of Regulation S.[312]

3. For persons other than dealers, certain other securities professionals, and officers and directors of the issuer or a distributor, the availability of the resale safe harbor is subject only to compliance with the offshore transaction requirement and the prohibition on directed selling efforts.

4. When the seller is a dealer or a person receiving a selling concession fee or other remuneration in respect of the securities offered or sold (a securities professional), and the offer or sale is made prior to the expiration of an applicable distribution compliance period with respect to such securities, then the resale safe harbor is available only if (1) neither the seller nor any person acting on its behalf knows that the offeree or buyer of the securities is a U.S. person and (2) the seller or any person acting on its behalf knows that the purchaser is a securities professional, a confirmation containing appropriate restrictive language is sent to the purchaser.

5. In the case of an offer or sale of securities by an officer or director of the issuer or a distributor who is deemed to be an affiliate of the issuer or distributor solely by virtue of holding such position, such officer or director may rely on the resale safe harbor, subject only to the offshore transaction requirement and the prohibition on directed selling efforts, provided that no selling concession, fee, or other remuneration is paid in connection with such offer or sale other than a usual and customary broker's commission.

6. The resale safe harbor is available for the resale offshore of any securities, whether or not acquired outside the United States. Resales pursuant to Regulation S of securities originally placed privately in the United States (including those pursuant to Rule 144A) will not affect the validity of the private placement exemption relied upon by the issuer.

D. Resale Limitations - Rule 905[313]

1. Equity securities of domestic issuers acquired from the issuer, a distributor, or one of their affiliates in a Regulation S transaction are deemed to be restricted securities as defined in Rule 144. Any resales of those restricted securities must be made pursuant to Regulation S, registration under the Securities Act, or pursuant to an exemption from registration.

2. Also, resales pursuant to Regulation S of equity securities of domestic issuers that are restricted securities do not "wash off" restricted security status.

[312] 17 C.F.R. §§ 230.901 – 903.

[313] 17 C.F.R. § 230.905.

E. Concurrent Offshore and U.S. Offerings

1. In determining whether the offshore transaction requirement has been satisfied, a registered offering or exempt private placement in the United States will not be integrated with an offshore offering that otherwise complies with Regulation S, and, conversely, that, in determining whether the requirements for an exempt private placement under Section 4(2)[314] have been satisfied, offshore transactions made in compliance with Regulation S will not be integrated with domestic offerings that are otherwise exempt from registration under the Securities Act.

F. Interaction Between Regulation S and Rule 144A

1. U.S. Sales of Unseasoned Securities. Rule 144A[315] has, in particular, facilitated primary and secondary sales of unseasoned securities, although particular care must be taken in the case of Category 2 and Category 3 issuances to ensure compliance with applicable offering restrictions pursuant to Regulation S, and, in the case of debt securities, the TEFRA D rules[316] under the Internal Revenue Code.[317] The effect of the combination of Regulation S and Rule 144A is to expand substantially the ability of U.S. investors to resell in the issuer's home market.

2. Resales Outside the U.S. Regulation S Safe Harbor. Resales under Rule 904 are permitted where the seller has not engaged in any directed selling efforts and the sale is made in an offshore transaction.

XVII. OTHER RELEVANT STATUTES CONCERNING REGISTRATION OF SECURITIES

A. Trading Restrictions

1. Regulation M under the Exchange Act[318] governs market activities of issuers, selling security holders, underwriters and other participants in securities offerings, and certain of their affiliates.The SEC believes that securities offerings present special opportunities and incentives for manipulation that require special regulatory attention. As a result, Regulation M restricts or prohibits certain activities during securities distributions (a term defined for Regulation M purposes in that rule and different from distribution for Securities Act purposes).

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[314] 15 U.S.C. § 77d(2).

[315] 17 C.F.R. § 230.144A.

[316] Treas. Reg. §1.163-5 (c)(2)(i)(D) (2008).

[317] I.R.C. § 1 *et seq* (2008).

[318] 17 C.F.R. §§ 242.100 – 105.

B. Investment Company Act of 1940[319]

1. Private Offerings by Foreign Funds. Section 7(d) of the Investment Company Act[320] prohibits a foreign investment company from using jurisdictional means to offer its securities for sale publicly in the United States unless it receives an SEC order permitting it to register under the Investment Company Act.

a) Section 3(c)(1) of the Investment Company Act excludes from the definition of “investment company” "any issuer whose outstanding securities . . . are beneficially owned by not more than 100 persons and which is not making and does not intend to make a public offering of its securities."[321] The SEC recently proposed amendments to the definition of "accredited investor" with respect to individuals that would apply only to offerings of 3(c)(1) companies (principally hedge funds).[322]

b) The Rule 144A adopting release[323] cites the Touche Remnant interpretive letter,[324] in which the SEC took the position that a foreign investment company may engage in a private offering the United States as long as the offering did not cause the company's shares to be beneficially owned by more than 100 U.S. residents. The term "public offering" in Section 7(d) of the Investment Company Act was interpreted to include an offer by jurisdictional means that causes the shares of the foreign investment company to be beneficially owned by more than 100 U.S. residents at any point, even after the completion of a good private placement with acceptable Rule 144A resales.

c) This position has made it difficult for foreign investment companies to execute Rule 144A offerings in the United States without the imposition of ongoing, cumbersome transfer restrictions to maintain the 100 U.S. residents beneficial owner limit. Under this practice, restrictions are not applied to securities that were originally sold or subsequently resold outside the United States on the theory that they do not result from a U.S. private placement in the United States.

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[319] 15 U.S.C. § 80a(1)(65).

[320] 15 U.S.C. § 80a7(d).

[321] 15 U.S.C. § 80a3(c)(1).

[322] *See* Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8828, Investment Company Act No. 27922, 72 Fed. Reg. 45,116 (Aug. 10, 2007).

[323] Adoption of Rule 144A, Securities Act Release No. 6862, Exchange Act Release No. 27928, Investment Company Act Release 17452, 55 Fed. Reg. 17,933 (Apr. 30, 1990).

[324] SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) 77810 (Aug. 27, 1984).

The release went on to concur with the position of Touche Remnant that this was a maintenance test and not an incurrence test.[325]

2. Section 3(c)(7) of the Investment Company Act,[326] added in 1996,[327] facilitates private offerings by U.S. and foreign investment companies by exempting from the definition of "investment company" entities whose securities are not publicly offered in the United States and are exclusively owned by an unlimited number of qualified purchasers that own or invest on a discretionary basis a specified amount of investments. The definition of "qualified purchasers", which is significantly broader than the QIB definition, provides increased flexibility for funds owned by highly-sophisticated investors. Unlike Section 3(c)(1), with its 100-owner limit and resulting issues discussed above, there is no limit to the number of qualified purchasers an issuer may have as investors under Section 3(c)(7). A foreign investment company making a private offering of its securities in the United States must therefore comply with Section 3(c)(7) with respect to its securities sold directly to U.S. residents or subsequently transferred by such U.S. residents to other U.S. residents. Securities that flow from offshore into the United States in secondary market trading need not be counted. Even under these principles, U.S. secondary market transactions must be monitored to ensure that any U.S. resident purchaser is a qualified purchaser. In the early stages of practice under Section 3(c)(7), all deals required physical certificates and investor certifications. However, procedures have now been developed and implemented by the market to trade such securities through the Depository Trust Company and they are rarely certificated.

C. FINRA Rules

1. Filing Requirements. Rule 144A transactions (and other private placement transactions) are offerings that are exempt from NASD Rule 2710,[328] FINRA's Corporate Financing Rule. Accordingly, securities offerings made under Rule 144A are exempt from the filing requirements of those provisions.

2. Distribution Rules. Rule 144A transactions are not subject to NASD Rules 2730,[329] 2740[330] and 2750[331] (the so-called "Papilsky

[325] *See* Goodwin, Proctor & Hoar, SEC No-Action Letter, 1997 WL 86002 (Feb. 28, 1997).

[326] 15 U.S.C. § 80a3(c)(7).

[327] *See* National Securities Markets Improvement Act, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended in scattered sections of 15 U.S.C.).

[328] NASD Rule 2710 “Corporate Financing Rule-Underwriting Terms and Arrangements.”

[329] NASD Rule 2730 “Securities Takes in Trade”

[330] NASD Rule 2740 “Selling Concessions, Discounts, and Other Allowances.”

Rules") or Article Ill, Section 24(b)(2) of the NASD Rules of Fair Practice or Rule 2790,[332] the NASD's Rule on "free-riding and withholding".

3. Reporting Requirements. The NASD Rules Series 6600[333] and 6700[334] reporting requirements for FINRA members that trade equity securities in the non-Nasdaq over-the-counter market do not apply to Rule 144A transactions.

4. Regulation S Offerings. Regulation S[335] offerings are, by their nature, outside the scope of the NASD Corporate Financing Rule and the Papilsky Rules.

D. Blue Sky

1. The Blue Sky laws of every state contain an exemption for the sale of securities to specified classes of institutional buyers. The definition of "QIB" in Rule 144A offerings is broad enough to meet this exemption in most states.

E. Margin Regulations

1. Regulation T.[336] Regulation T limits the amount of credit a broker dealer may extend for the purpose of purchasing or carrying securities.

a) The Federal Reserve Board, which interprets the margin regulations, has stated that it will treat the purchase by a broker dealer of debt securities for resale pursuant to Rule 144A as an investment banking service under the "arranging provision" of Regulation T.[337] Furthermore, the interpretation states the Board's position that market-making activities by broker dealers who hold themselves out to other institutions as willing to buy and sell Rule 144A securities on a regular and continuous basis may also be considered an investment banking service under the arranging provision of Regulation T. This interpretation is quite helpful, since credit arranged to be extended in connection with investment banking services is exempt from the general prohibition against broker dealers arranging for extension of credit it would itself be prohibited from extending under Regulation T.

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[331] NASD Rule 2750 "Transactions with Related Persons."

[332] NASD Rule 2790 "Restrictions on the Purchase and Sale of Initial Equity Public Offerings."

[333] NASD Rule 6600 "Over-The-Counter Equity Securities."

[334] NASD Rule 6700 "Transaction Reporting in PORTAL Securities."

[335] 17 C.F.R. § 230.501.

[336] 12 C.F.R. § 220.1 *et seq*.

[337] 12 C.F.R. § 220.127.

b) Thus, a broker dealer may purchase, as principal, a new issue of unsecured debt securities intended to be resold under Rule 144A where the proceeds are, or may be, applied by the issuer to purchase or carry securities, including an offering intended to finance merger and acquisition transactions, venture capital investments, or portfolio arbitrage. The interpretation also facilitates offerings of debt securities where there is no specific use of proceeds identified at the time of the offering, but where the debt securities may ultimately finance a business combination or where the proceeds may be invested for a substantial period of time in securities.

c) As a general matter, Rule 144A securities are not marginable under Regulation T. However, a broker dealer may arrange for a non- broker dealer to finance the purchase of such securities pursuant to the "private placement exception" to the Regulation T arranging provision.[338]

2. Section 11(d)(1) of the Exchange Act.[339] Section 11(d)(1) of the Exchange Act prohibits the extension of credit by broker dealers in connection with the distribution of new issues of securities until 30 days following the end of the distribution (including sales of unsold allotments by the lender). The SEC has not provided any specific guidance as to the definition of "distribution," but it is generally considered broad enough to cover Rule 144A/Regulation S offerings. However, there is an interpretation stating that Rule 144A offerings that are exempt from Regulation M should also be outside of the reach of Section 11(d).

F. Trust Indenture Act[340]

1. Rule 144A/Regulation S debt offerings are exempt from the registration requirements of the Securities Act, therefore, no indenture need be qualified under the Trust Indenture Act. Thus, the agreement under which the debt securities are issued can take the form of a fiscal agency agreement. It is not unusual for Rule 144A/Regulation S offerings, particularly of U.S. issuers, to have registration rights where the offerings are followed by a registered exchange offering or shelf, in which case the Rule 144A/Regulation S debt securities should be issued under a qualifiable indenture.

G. Legal Investment

[338] *See* 15 U.S.C. § 77d(2).

[339] 15 U.S.C. § 78k(d)(1).

[340] 15 U.S.C. §§ 77aaa – bbb.

1. The legal investment statutes applicable to certain regulated institutions may restrict the purchase of securities by those institutions under Rule 144A. In certain states, for example, savings banks are not permitted to purchase corporate debt securities unless the securities are marketable. It appears that whether securities sold under Rule 144A will be deemed marketable will depend, in each offering, upon the nature of the security, the size of the offering, the breadth of distribution, and the quality and depth of the secondary market for the security. Other institutions that may be restricted to the purchase of marketable or liquid securities, and therefore subject to restrictions in the purchase of securities under Rule 144A, include national banks, state commercial banks, federal and state savings associations, and federal savings banks.

2. Although state insurance laws generally do not impose a liquidity requirement upon insurance company investments, in certain states insurance companies may not invest (except under "basket clauses") in common stocks not listed on a U.S. exchange or quoted in Nasdaq (i.e., the type of common stocks eligible for sale under Rule 144A).

3. It is also not unusual for investment companies to have contractual restrictions on the percent of net assets which may be invested in restricted securities.

4. Where Rule 144A securities are registered for resale on a resale shelf registration statement (as opposed to exchanged pursuant to a registered exchange offer), it is not clear whether the security is a marketable security until it is sold through the resale registration statement by the Rule 144A investor for purposes of regulatory or contractual restricted securities baskets.

XVIII. PRIVATE PLACEMENTS TURNED INTO PUBLIC OFFERINGS AND PUBLIC OFFERINGS TURNED INTO PRIVATE PLACEMENTS

A. Integration Doctrine. An issue with respect to various exemptions has been whether a private offering of securities should be viewed as part of another past, present, or future offering of securities by same issuer, with the results that such a private offering would be deemed to be part of a public offering. There are several safe harbors.

1. Five Factors. In determining whether to integrate separate offerings, the following five factors are relevant to the issue of integration:

a) The different offerings are part of a single plan of financing;

b) The offerings involve issuance of the same class of security;

c) The offerings are made at or about the same time;

d) The same type of consideration is to be received; and

e) The offerings are made for the same general purpose.

2. Six Months Rule. Rule 502(a) of Regulation D[341] excludes from integration offerings more than six months before or after a Regulation D offering so long as there are not offers or sales of the same or similar type of security as those offered or sold in the Regulation D offering during the six month periods before and after the Regulation D offering.

3. Safe Harbor for Offshore Offerings. Offshore sales under Regulation S generally would not be integrated with offerings in the United States.

4. Rule 152[342] provides: "The phrase transaction by an issuer not involving any public offering in Section 4(2)[343] . . . shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement."[344] The adopting release for Rule 152 stated that the "rule allows those who have contemplated or begun to undertake a private offering to register the securities without incurring any risk of liability as a consequence of having first contemplated or begun to undertake a private offering."[345] Rule 152 stands as an exception to the integration doctrine. If a good private placement is either completed or abandoned, that transaction will not be integrated with a later public offering of additional securities (or of the abandoned unsold securities). As a result of Rule 152, the two offerings will not be integrated and the five-factor integration test need not be applied.

5. Rule 155.[346] Addressing Integration Problems.

a) An issuer begins a private offering, abandons it without selling any securities, and begins a registered public offering. In this situation, the issuer faces the integration problem that marketing activity in the private placement constitutes pre-filing offers, or gun jumping, in violation of Section 5(c).[347] Rule 155(b) allows the issuer to commence

[341] 17 C.F.R. § 230.502.

[342] 17 C.F.R. § 230.152.

[343] 15 U.S.C § 77d(2).

[344] 17 C.F.R. § 230.152 (footnote added).

[345] Securities Act Release No. 4761, 30 FR 2022 (Feb. 5, 1965).

[346] 17 C.F.R. § 230.155.

[347] 15 U.S.C. § 77e(c).

a public offering 30 days after abandoning the private offering, subject to certain conditions.[348]

b) An issuer is unable to complete a public offering and, prior to selling any securities, wishes to withdraw the registration statement and begin a private offering. In this situation the issuer faces the integration problem that the filing of the registration statement constitutes a general solicitation, in violation of the Section 4(2),[349] Section 4(6),[350] and Regulation D[351] private placement exemptions. Rule 155(c) allows the issuer to commence the private offering 30 days after withdrawing the registration statement, subject to certain conditions.

c) The Rule 155 safe harbor applies only to private placements pursuant to Section 4(2), and Section 4(6), and Rule 506 of Regulation D.[352]

(1) Rule 155 is only a safe harbor for integration. Issuers must still meet the conditions for a private placement exemption under Section 4(3), Section 4(6) or Rule 506 of Regulation D.

(2) Safe harbor for changing a private offering into a registered offering – Rule 155(b).[353] Rule 155(b) enables an issuer to abandon a private offering and commence a public offering under the following conditions:

(a) No securities are sold in the private offering;

(b) All offering activity is terminated prior to filing the registration statement;

(c) The prospectus for the public offering discloses certain information about the private offering including:

(i) The size and nature of the private offering;

[348] 17 C.F.R. § 230.155(b).

[349] 15 U.S.C. § 17d(2).

[350] 15 U.S.C. § 17d(6).

[351] 17 C.F.R. § 230.501.

[352] 17 C.F.R. § 230.506.

[353] 17 C.F.R. § 230.155.

(ii) The date on which the issuer terminated all offering activity in the private offering;

(iii) All offers to buy or indications of interest were rejected by the issuer; and

(iv) The prospectus delivered in the registered offering supersedes any selling material used in the private offering; and

(d) The registration statement is not filed until at least 30 days after termination of all offering activity, unless the private offering was made only to accredited or sophisticated investors, in which case the issuer may file immediately after terminating the private offering.

(e) The Rule 155(b) safe harbor does not specify what steps are necessary to terminate offering activity. Issuer must cease actively soliciting investors. In order to establish compliance, offerors probably should notify private offerees that the offer has been terminated and, possibly, ask for return of private placement memo.

d) Rule 155(c)[354] enables an issuer to abandon a registered offering and commence a private offering under the following conditions:

(1) No securities are sold in the registered offering;

(2) The issuer withdraws the registration statement;

(3) The private offering does not commence until 30 days after withdrawal of the registration of the registration statement;

(4) The issuer notifies the private offerees that:

(a) The offering is not registered under the Securities Act;

(b) The securities will be "restricted securities" as defined in Rule 144 and cannot be resold without registration unless an exemption is available;

(c) Purchasers do not have the protection of Section 11 of the Securities Act; and

[354] 17 C.F.R. § 230.155.

(d) A registration statement for the abandoned offering was filed and withdrawn, specifying the effective date of the withdrawal; and

(5) Any private offering materials must disclose any material changes to the issuer's affairs since the filing of the registration statement that are "material to the investment decision in the private offering."[355]

6. Amendment to Rule 477.[356] Rule 477 provides that if the registration statement is not yet effective, its withdrawal is automatic upon request, unless the SEC objects within 15 calendar days.

7. If applicable, the withdrawal application should state that the issuer may commence a private placement pursuant to the Rule 155(c) safe harbor. If the SEC does not object, the 30 day waiting period is measured from the date the SEC finally approves the withdrawal. The Rule 155(c) safe harbor is not precluded by the fact that the registration statement has already been declared effective. However, Rule 477[357] makes withdrawal automatic (unless the SEC objects in 15 days) only if the registration statement has not become effective.

XIX. NASDAQ PORTAL MARKET[358]

A. Background:

1. The NASD created the PORTAL Market in 1990 simultaneously with the SEC's adoption of Rule 144A under the Securities Act to be a new trading system for the purpose of quoting, trading, and reporting trades in securities eligible for resale by QIBs under Rule 144A.

2. The PORTAL Market initially did not develop as anticipated, arguably because PORTAL securities were exclusively traded on PORTAL and the original PORTAL Rules imposed trade reporting for all transaction in PORTAL securities at a time when there were no trade reporting requirements for privately placed securities.

3. In 2001, the SEC approved a rule change filed by NASD to delete many features that had become obsolete, including rules governing the registration of PORTAL Dealers, PORTAL Brokers, and PORTAL Qualified Investors and rules that were intended to

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[355] 17 C.F.R. § 230.477.

[356] 17 C.F.R. § 230.477.

[357] 17 C.F.R. § 230.477.

[358] PORTAL was originally approved by the SEC in 1990. *See* SEC Release No. 27956 (April 27, 1990); 55 FR 18781 (May 4, 1990).

regulate the quotation sand trade reporting of PORTAL securities between PORTAL participants using the PORTAL system. Following approval of this change, Nasdaq's primary role became designating securities as PORTAL eligible which made those securities eligible for book entry services as The Depository Trust Company ("DTC").

B. Nasdaq PORTAL Market Amendments.

1. On July 31, 2007, the SEC approved amendments[359] to reestablish a quotation and trading system, the PORTAL Market for securities that are designated by Nasdaq as PORTAL securities.

2. The amendments create a more efficient institutional resale market for unregistered securities which will serve the public interest by providing a central, though not exclusive, location for the quotation, trade negotiation, and trade reporting of Rule 144A securities.

3. Previously, broker dealers traded securities pursuant to Rule 144A in the OTC market, but there was no established framework for quotation or trade reporting in Rule 144A securities.

C. Amended PORTAL Market

1. Security Designation. Limited to Rule 144A securities that are initially sold to QIBs by a broker dealer acting as an initial placement agent or initial purchaser.

2. Broker Dealer Access. "PORTAL Dealers" can trade as principal and "PORTAL Brokers" can act as an agent for customers. Both are permitted to post anonymous one- or two-sided indicative quotations in PORTAL securities. Also, both are permitted to negotiate anonymously and execute trades in PORTAL securities.

3. QIB Access. An institution that executes a subscriber agreement, agrees to comply with the PORTAL rules and meets the $100 million and other standards in Rule 144A to be a QIB would be qualified to be a "PORTAL Qualified investor," which are permitted to access to the PORTAL Market through a password-protected linkage and view quotations of PORTAL Dealers and PORTAL Brokers, and confirm transactions when the PORTAL Qualified investor uses a PORTAL Dealer or PORTAL Broker to execute a trade in PORTAL. PORTAL Qualified Investors are not permitted to enter quotations in the PORTAL system or enter orders directly into PORTAL.

4. Trade Negotiation/Execution. PORTAL allows PORTAL Dealers and PORTAL Brokers to negotiate openly and anonymously and

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[359] *See* Order Approving Proposed Rule Change to Reestablish The PORTAL Market, Exchange Act Release No. 56172, 72 Fed. Reg. 44196 (Aug. 7, 2007).

execute trades in PORTAL securities. PORTAL Qualified investors are not permitted to participate in negotiations. Once an anonymous trade was negotiated in PORTAL, the identity of the counter-parties would be revealed to each other for purposes of comparison, confirmation, and settlement of trade.

5. Trade Reporting. Trade reports in reportable PORTAL debt and equity securities pursuant to NASD Rule 6732 would be forwarded by Nasdaq to TRACE and the OTC Reporting Facility.

6. Dissemination of PORTAL Trade Report Information. Trade report information for trades negotiated via PORTAL is disseminated in PORTAL to PORTAL Brokers, PORTAL Dealers, and PORTAL Qualified Investors, but would not include the identity of the parties and, in the case of PORTAL debt, would not aggregate or otherwise follow the protocols for debt trades reported to TRACE.

7. Settlement. Trades in equity securities that have been compared and confirmed are automatically forwarded to an appropriate subsidiary of Depository Trust & Clearing Corporation ("DTCC") for settlement.

8. Regulatory Surveillance. NASD currently provides and will continue to provide surveillance of the trade reports in PORTAL securities that are submitted through TRACE and OTC Reporting Facility.

D. Exemption from Section 36 of the Exchange Act.[360]

1. Pursuant to Section 36 of the Exchange Act,[361] the SEC stated that a Nasdaq member, broker, or dealer may effect a transaction on the PORTAL Market, and any successor trading facility that maintains compliance for sales under Rule 144A, in a security that has not been registered under Section 12(b)[362] of the Exchange Act without violating Section 12(a)[363] of the Exchange Act

2. Nasdaq will designate securities as PORTAL securities and PORTAL participants can trade with one another in a closed system.

3. PORTAL designation is limited to those Rule 144A securities that are initially sold to QIBs by a broker or dealer acting as an initial placement agent or an initial purchaser. Nasdaq would continue to qualify restricted securities as that term is defined in

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[360] Order Granting the NASDAQ Stock Market LLC's Application for an Exemption Pursuant to Section 36 of the Securities Exchange Act, Exchange Act Release No. 56176 (July 31, 2007).

[361] 15 U.S.C. § 78m(m).

[362] 15 U.S.C. § 78l(b).

[363] 15 U.S.C. § 78l(a).

SEC Rule 144(a)(3),[364] and securities that are restricted pursuant to contract or through the terms of the security, for designation as PORTAL securities based on, among other things, the requirements for the resale of a security under Rule 144A(d)(3)[365] and (d)(4).[366]

XX. CATEGORIES OF ISSUERS AND REGISTRATION MECHANICS

A. Four Categories of Issuers

1. Non-reporting issuers. These are issuers that are not required to file reports pursuant to Section 13[367] or 15(d)[368] of the Exchange Act. Section 13 and 15(d) of the Exchange Act require companies with outstanding public securities to, among other things, provide regular periodic reports (annual reports on Form 10-K[369] and quarterly reports on Form 10-Q[370] for domestic issuers and annual reports on Form 20-F[371] for foreign private issuers) and current reports (Form 8-K[372]).

2. Unseasoned issuers. These are issuers that are required to file reports pursuant to Section 13 or 15(d) of the Exchange Act, but do not satisfy the requirements of the SEC's Form S-3 or Form F-3 for primary offerings of securities pursuant to the Securities Act.

3. Seasoned issuers. These are issuers that are eligible to use Form S-3 or Form F-3 to register primary offerings of securities.

4. Well-known seasoned issuers ("WKSIs"). These are seasoned issuers that either:

    a) Have outstanding voting and non-voting common equity held by non-affiliates with a worldwide market value of $700 million or more; or

    b) Have issued in the last three years at least $1 billion aggregate primary amount of non-convertible securities (whether or not investment grade), other than common equity, in primary offerings for cash (not exchange)

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[364] 17 C.F.R. § 230.144(a)(3).

[365] 17 C.F.R. § 230.144A(d)(3).

[366] 17 C.F.R. § 230.144A(d)(4).

[367] 15 U.S.C. § 78m.

[368] 15 U.S.C. § 78o(d).

[369] Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act, SEC, http://www.sec.gov/about/forms/form10-k.pdf.

[370] Form 10-Q, SEC, http://www.sec.gov/about/forms/form10-q.pdf.

[371] Form 20-F, SEC, http://www.sec.gov/about/forms/form20-f.pdf.

[372] Form 8-K: Current Report Pursuant to Section 13 or 15(d) of the Securities Act, SEC, http://www.sec.gov/about/forms/form8-k.pdf.

registered under the Securities Act. A company cannot be a WKSI if it is an "ineligible issuer" at the relevant determination date.

5. Unseasoned issuers, seasoned issuers, and WKSIs are all collectively known as "reporting issuers."

B. Registration mechanics. Registration of public securities offerings is done on forms prescribed by rule and filed with the SEC.

1. Forms S-1[373] and F-1.[374]

a) These "long form" registration statements are used for IPOs by non-reporting issuers. Issuers become obligated to file regular, ongoing reports with the SEC under Section 13 or 15(d) of the Exchange Act once they have publicly registered securities.

(1) These forms do not permit incorporation by reference.

b) Unseasoned issuers (those that do not meet the requirements to use Forms S-3 or F-3) must use Form S-1 or F-1 to register their offerings. Once an issuer has filed at least one annual report on Form 10-K or Form 20-F, it may "incorporate by reference" the information in its previously filed Exchange Act reports into its registration statement on the S-1 or F-1.

c) In light of the requirements for use of Forms S-3 and F-3, unseasoned issuers will most commonly be:

(1) All companies during the 12 months following their initial public offerings;

(2) Public companies that have registered only debt securities and therefore cannot meet the public float requirement, including when they make their initial public offerings of equity securities;

(3) Small public companies that, while having publicly registered equity, do not meet the $75 million test for Forms S-3 and F-3; or

(4) Any reporting company that has been late in a filing obligation under the Exchange Act during the past 12 months or has committed one of the noted dividend or debt defaults, and has thus lost its

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[373] Form S-1: Registration Statement under the Securities Act, SEC, http://www.sec.gov/about/forms/forms-1.pdf.

[374] Form F-1: Registration Statement under the Securities Act, SEC, http://www.sec.gov/about/forms/formf-1.pdf.

eligibility to use Form S-3 or F-3 until those tests are met again.

2. Forms S-3[375] and F-3[376]/Integrated Disclosure System

a) These forms permit S-3 and F-3 registrants to incorporate by reference Exchange Act reports filed with the Registration Statement.

b) In order to qualify to use Form S-3 or F-3 for a primary equity offering, an issuer must:

(1) Have a public float of at least $75 million;

(2) Have been subject to the reporting requirements under Section 13 or 15(d) of the Exchange Act for at least 12 months and have filed all required reports in a timely fashion during the past 12 months, except for certain reports on Form 8-K; and

(3) Have paid all dividend or sinking fund installments on preferred stock and not have defaulted on any material installment on indebtedness or rental on one or more long-term leases, in each case since the end of its last fiscal year for which audited financial statements have been filed in a Exchange Act report.

c) Issuers that meet the requirements to use these forms are known as "seasoned issuers."

d) Issuers using Forms S-3 and F-3 may incorporate by reference to their Exchange Act reports in order to provide large portions of the information required in their registration statements. Offerings registered on these forms that are completed on a delayed basis are commonly called "shelf offerings" because the securities are registered (and the registration statement is declared effective by the SEC staff) at one point in time, and then subsequently "taken down" when actual sales are made.[377]

e) "Universal shelves" allow seasoned issuers to register different types of securities (debt and equity) on a single registration statement. An issuer filing on Form S-3 or Form F-3 may also take advantage of "forward incorporation by reference," by which its registration statement incorporates

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[375] Form S-3: Registration Statement under the Securities Act, SEC, http://www.sec.gov/about/forms/forms-3.pdf.

[376] Form F-3: Registration Statement under the Securities Act, SEC, http://www.sec.gov/about/forms/formf-3.pdf.

[377] *See* Securities Act Rule 415 (17 C.F.R. § 230.415).

Exchange Act reports that are filed after the registration statement is declared effective. Standard Forms S-3 and F-3 are subject to review by, and must be declared effective by, the staff of the SEC.

3. Automatic Shelf Registration

a) Automatic shelf registration (“ASR”) is available only to WKSIs and is a subset of Forms S-3 and F-3. Most significantly for a discussion of the registration process, an ASR goes effective automatically and immediately, without any review or required action by the SEC staff. An ASR also offers numerous other mechanical and procedural advantages over regular S-3 or F-3 registration.

XXI. AMERICAN DEPOSITORY RECEIPT (“ADRs”)

A. U.S. investors can purchase foreign issuers’ securities by purchasing ADRs, which are receipts that are issued by a U.S. depository bank, that represent shares that are held overseas.

B. An offering of ADRs is made pursuant to the Securities Act by use of Form F-6.[378]

1. In order to use Form F-6, a foreign issuer must be in compliance with Exchange Act reporting requirements or must obtain an exemption from such requirements pursuant to Exchange Act Rule 12g3-2(b).[379]

2. Rule 12g3-2(b) exempts securities of a foreign issuer from registration under Section 12(g)[380] of the Exchange Act, provided foreign issuer furnishes SEC “with copies of material information made public in its local jurisdiction or sent to foreign security holders.”[381]

C. ADRs can also be registered by filing Form F-1, F-2, or F-3.

D. Once an ADR program is established, ADRs trade freely on either Nasdaq, NYSE or AMEX.

E. Two types of ADR programs

1. Sponsored

2. Unsponsored

F. Three types of Sponsored ADR programs

1. Level I

[378] 17 C.F.R. § 239.36.

[379] 17 C.F.R. § 240.12g3-2(b).

[380] 15 U.S.C. 78l(g).

[381] 17 C.F.R. § 240.12g3-2(b).

2. Level II

3. Level III

G. An unsponsored ADR program is one that is initiated by U.S. depositary bank. The bank establishes the ADR with the knowledge, but not the “active cooperation,” of the foreign issuer, and files Form F-6.

H. A sponsored ADR program is one where a foreign company appoints a U.S. depositary bank which sponsors their entry into the U.S. capital markets.

1. The foreign issuer files Form F-6 for the ADRs and Form F-1, F-2, or F-3 for its underlying shares (S-1, S-2, S-3).[382]

2. The foreign issuer signs a service contract with a depository bank, agrees to pay them fees and also agrees to provide shareholder communications though the depositary bank.

3. Pursuant to Exchange Act Rule 15d-3,[383] “annual and other reports are not required to be filed as a result of registering ADRs on Form F-6.”[384]

4. Although ADRs are exempt from registration pursuant to Section 12(g)[385] and Rule 12g3-2(c),[386] exemption is not available for underlying deposited shares.

5. In order for an ADR to be listed on a U.S. stock exchange or quoted on Nasdaq, it must be registered pursuant to Section 12(b)[387] or Section 12(g) of Exchange Act, respectively, and a Registration Statement and an annual report on Form 20-F must be filed.

6. Form 20-F is a combined Registration Statement and reporting form authorized for use by foreign issuers under the Exchange Act.

I. Level I ADR

1. A sponsored Level I ADR trades OTC in the “pink sheets.”

2. Established through an “information exemption” pursuant to Exchange Rule 12g3-2(b); all the foreign company has to do is supply SEC with any material information they produce and distribute locally in their home country.

3. Because it is not registered with the SEC, it cannot be listed on U.S. securities exchange, nor can it be used to raise capital.

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382 17 C.F.R. § 239.33.

383 17 C.F.R. § 240.15d-3.

384 17 C.F.R. § 240.15d-3.

385 15 U.S.C. § 78l(g).

386 17 C.F.R. § 240.12g3-2(c).

387 15 U.S.C. § 78l(b).

4. A low-cost way of entering the U.S. securities market. This is often the first step to listing on a U.S. securities exchange.

J. Level II ADR

1. Used when a foreign company decides to list on a U.S. securities exchange.

2. The foreign company is required to file a Form 20-F, pursuant to the Exchange Act, which entails complying with or reconciling the foreign company's financial statements to U.S. GAAP.

K. Level III ADR

1. Used when a foreign company decides to make a public offering in the U.S., which requires filing a Form F-1 (foreign equivalent to an S-1) with the SEC and complying with U.S. accounting and disclosure standards.

L. Issues: Deregistration

1. On March 27, 2007, the SEC adopted new rules that will make it easier for foreign private issuers to terminate the registration of securities under Section 12(g) and their reporting obligations under Section 13(a)[388] or 15(d)[389] of the Exchange Act.

2. Under current rules, a foreign private issuer, even if delisted from the U.S. exchanges and experiencing little trading activity in the United States, could only exit from the SEC's reporting requirements if it had fewer than 300 record holders who were U.S. residents.

3. Under the new Rule 12h-6,[390] a foreign private issuer may terminate its SEC registration and reporting obligations with respect to a class of equity securities if the trading volume for that class of securities in the United States (based on number of shares traded) has been 5% or less of the worldwide average trading volume of that class of securities for a recent 12-month period, assuming it meets the other conditions of Rule 12h-6.

a) The 5% trading volume threshold will be calculated by comparing a foreign private issuer's U.S. trading volume to its worldwide trading volume, rather than comparing it to trading volume in the foreign private issuer's one or two primary markets, as originally had been proposed.

b) Off-market trading (including transactions through alternative trading systems) will be counted worldwide, as long as the trading volume information regarding the off-

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[388] 15 U.S.C. § 78m(a).

[389] 15 U.S.C. § 78o(d).

[390] 17 C.F.R. § 240.12h-6.

market transactions is reasonably reliable and does not duplicate other trading volume information regarding the subject class of securities.

c) Convertible debt and other equity-linked securities will no longer be included in the definition of "equity security" for purposes of the trading volume calculation.

4. In addition to the 5% trading volume test, the new rule includes several conditions that must be satisfied in order for the issuer to benefit.[391]

a) An issuer that delists in the United States prior to deregistering under Rule 12h-6 must meet the trading volume standard at the date of delisting or otherwise wait 12 months before it can proceed with deregistration. An issuer that terminates an American Depositary Receipt facility must wait 12 months from such termination before seeking deregistration. The adopting release contains a transition provision which provides that these delisting and ADR termination conditions would not apply to an issuer that (1) delisted or (2) terminated a sponsored ADR facility before March 21, 2007.

b) An issuer of equity securities must have been an Exchange Act reporting company for at least one year, have filed or submitted all Exchange Act reports required for the period, and have filed at least one Exchange Act annual report or special financial report pursuant to Rule 15d-2.[392]

c) An issuer of equity securities must not have sold securities in a registered offering in the United States during the preceding 12 months, other than certain exempted securities offerings (such as offerings to the issuer's employees, offerings by selling security holders in a non-underwritten offering, or offerings pursuant to a dividend or interest reinvestment plan).

d) An issuer of equity securities must have maintained a listing of the subject class of securities for at least a year in a foreign jurisdiction that, either singly or together with one other foreign jurisdiction, constitutes the primary trading market for the issuer's subject of securities.

5. The final rule also confirms that the trading volume test is not the only manner in which a foreign private issuer may deregister a class of securities. Specifically, foreign private issuers that have fewer than 300 record holders on a worldwide basis, or fewer than

[391] 17 C.F.R. § 240.12h-6.

[392] 17 C.F.R. § 240.15d-2.

300 record holders who are U.S. residents, and that meet the above conditions may also deregister a class of securities pursuant to Rule 12h-6.[393] In this regard, the SEC's final rule also provides that, instead of having to look through the accounts of brokers, banks and other nominees on a worldwide basis to determine the number of its U.S. resident holders (as is required under the current rules), a foreign private issuer can limit its inquiry to brokers, banks and other nominees located in the United States, the issuer's jurisdiction of incorporation, and, if different, the jurisdiction of its primary trading market.

6. Rule 12h-6 requires a foreign private issuer to file a Form 15F electronically on EDGAR, certifying that it meets the requirements for terminating its Exchange Act registration and reporting obligations. The filing of the Form 15F will immediately suspend a foreign private issuer's Exchange Act reporting obligations and commence a 90-day waiting period. If, at the end of this 90-day period, the SEC has not objected to the filing, the suspension will automatically become a termination of registration and reporting. If the SEC denies the deregistration filing, the foreign private issuer will have 60 days in which to bring its Exchange Act reporting obligations current.

7. In connection with its deregistration pursuant to Rule 12h-6, a foreign private issuer will be required to publish, either before or on the date it files its Form 15F, a notice in the United States (such as a press release) that discloses its intent to terminate its Section 13(a) or 15(d) reporting obligations.

8. The issuer must also submit a copy of the notice to the SEC, either under a Form 6-K before or at the time of the filing of the Form 15F, or as an exhibit to the Form 15K.

9. A foreign private issuer that deregisters its securities under the Exchange Act will be immediately eligible for the exemption from registration provided by Rule 12g3-2(b).[394]

10. Study on Issuer Deregistration:

    a) Craig Doidge, G. Andrew Karolyi & Rene M. Stulz, *Why Do Foreign Firms Leave U.S. Equity Markets? An Analysis of Deregistrations under SEC Exchange Act Rule 12h-6* (August 2008).

        (1) The authors of the study examine the characteristics of 59 firms that immediately announced they would deregister under the new

[393] 17 C.F.R. § 240.12h-6.

[394] 14 C.F.R. § 240.12h-6.

rules, their potential motivations for doing so, as well as the economic consequences of their decision.

(2) Two competing theories offer predictions about the characteristics of and consequences for the deregistering firms.

(a) The first theory, which the authors call bonding theory, predicts that corporate insiders value a listing when their firm has valuable growth opportunities that they can finance on better terms by committing to the laws and rules that govern U.S. markets. The listing comes at a cost to insiders since it limits their ability to extract private benefits from their controlling position. If a firm is no longer expected to require outside finance because its growth opportunities have been taken advantage of or because they have disappeared, a listing is no longer valuable for insiders.

(b) The other theory, which the authors call the loss of competitiveness theory, predicts that firms deregister because the Sarbanes-Oxley Act of 2002 and, possibly, other regulatory developments, reduced the net benefits of a listing in the U.S. so that, for some firms, the value of a listing became negative. With this theory, foreign firms should have experienced wealth losses, and the introduction of the new deregistration rules and the deregistration announcements themselves should increase shareholder wealth.

(3) The authors found evidence that deregistering firms have poorer growth opportunities than other foreign firms with exchange listings and that these deregistering firms performed poorly prior to their deregistration announcements.

(4) They did not find any reliable evidence that foreign listed firms suffered from the Sarbanes-Oxley Act or that the Act had a more adverse impact on deregistering firms.

(5) Deregistering firms did not benefit from (and actually, in some tests, may have been hurt by) their deregistration announcements, and the shareholders of deregistering firms with better growth opportunities were affected more adversely by deregistration.

(6) None of these results are directly supportive of the loss of competitiveness theory. Some of these results are directly supportive of the bonding theory and others do not contradict it.

XXII. OVERVIEW OF REGISTRATION PROCESS – THREE PERIODS

A. Section 5[395] divides the registration process into three periods:

1. The Pre-Filing Period

a) The period between the time there is an agreement or understanding to issue and sell securities and the filing of the registration statement.

b) Under Section 5(c)[396] there cannot be an offer to sell or an offer to buy, by means of a prospectus or otherwise, any security until a registration statement has been filed.

c) Rule 163[397] exempts offers by WKSIs during the pre-filing period from the prohibition under Section 5(c), subject to compliance with the rule's conditions. This exemption applies only to the issuer, not to the underwriters in the WKSI offering.

2. The Waiting Period

a) The period between the filing of the registration statement and its being declared effective. WKSIs who are utilizing automatic shelf registration have no "waiting period."

b) Per Section 5(a)(1)[398], unless a registration statement is in effect as to a security, it is unlawful to "sell such security" by any prospectus or otherwise, but "offers" are not prohibited.

c) Per Section 5(b)(1)[399], during the waiting period, a prospectus that is used must meet the requirements of Section 10[400], but is not required to satisfy Section 10(a).

d) Rule 405[401] defines a "free writing prospectus" ("FWP") as any written offer outside of the prospectus in the registration statement. A free writing prospectus meets

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[395] 15 U.S.C. § 77e.

[396] 15 U.S.C. § 77e(c).

[397] 17 C.F.R. § 230.163.

[398] 15 U.S.C. § 77e(a)(1).

[399] 15 U.S.C. § 77e(b)(1).

[400] 15 U.S.C. § 77j.

[401] 17 C.F.R. § 230.405.

requirements of Section 10,[402] and therefore its use is permissible during waiting period, provided it is used in compliance with certain rules of the SEC.

3. The Post-Effective Period

   a) Section 5(a) provides that after the registration statement is "in effect", securities may be sold.

   b) Section 5(b)(2)[403] provides that a security cannot be delivered unless accompanied or preceded by a prospectus that meets the requirements of Section 10(a).

   c) The obligation to deliver a prospectus in order to sell the security may be fulfilled through filing the final prospectus with the SEC ("access equals delivery"), according to Rule 172.[404]

   d) Section 2(a)(10)[405] provides that written communications other than the prospectus in the registration statement ("statutory prospectus") may be used provided they are preceded or accompanied by the final statutory prospectus meeting the requirements of Section 10(a).

   e) During the post-effective period, confirms and notices of allocations may be sent to purchasers in the offering in that manner. Per Rule 405,[406] other written offers will not be free writing prospectuses if accompanied or preceded by the final prospectus.

   f) This exemption expressly applies to confirms and notices of allocation (so that the final prospectus does not need to be sent with those documents). It does not apply to any other written communications, which would therefore continue to be free writing prospectuses and subject to those rules unless preceded or accompanied by the final statutory prospectus.

4. Rule 174[407] – Research Analyst Quiet Periods.

XXIII. THE PRE-FILING PERIOD

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[402] 15 U.S.C. § 77j.

[403] 15 U.S.C. § 77e(b)(2).

[404] 17 C.F.R. § 230.172.

[405] 15 U.S.C. § 77b(a)(10).

[406] 17 C.F.R. § 230.405.

[407] 17 C.F.R. § 230.174.

A. Under Section 5(c), it is unlawful "to offer to sell or offer to buy . . . any security, unless a registration statement has been filed as to such security."[408]

B. An "offer" for the purposes of Section 5(c) encompasses a broad array of activities that would not fit within the definition of "offer" at common law.

C. During the pre-filing period, a security cannot be offered (except by a WKSI) or sold, prospective purchasers cannot be contacted, a prospectus cannot be used (except by a WKSI), and prospective underwriters cannot be publicly identified. These prohibited activities are referred to as "gun jumping."

D. Because WKSIs are allowed to make pre-filing offers and communications, they do not face the same risks of "gun jumping" as other issuers.

E. Rule 163,[409] which permits WKSIs to make pre-filing offers, contains several conditions with which WSKIs must comply. If those conditions are not met, a WKSI would be subject to the same consequences for gun jumping as any other issuer.

F. Preliminary Negotiations

   1. Section 2(a)(3)[410] provides that the terms "offer to sell" and "offer to buy" do "not include preliminary negotiations or agreements between an issuer [or controlling person] . . . and any underwriter or among underwriters who are or are to be in privity of contract with an issuer [or controlling person]."[411]

   2. Letter of Intent

      a) It identifies conditions that underwriters expect, e.g., earnings;

      b) Establishes who pays what; and

      c) Is not binding, except for any reimbursements if the underwriting is not effected.

G. Pre-Filing Public Announcement of an Offering

   1. Rule 135[412] provides that a notice of a proposed offering is not deemed an "offer" if it states that the offering will be made only by prospectus and the notice contains no more than the following:

      a) Name of issuer;

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[408] 15 U.S.C. § 77e(c).

[409] 17 C.F.R. § 230.163.

[410] 15 U.S.C. § 77b(a)(3).

[411] 15 U.S.C. § 77b(a)(3).

[412] 17 C.F.R. § 230.135.

b) Title, amount and basic terms of the securities;

c) Amount to be offered by any selling security holders;

d) Anticipated timing of the offering;

e) Brief statement of manner and purpose of the offering without naming the underwriters (naming underwriters would tell prospective purchasers whom to approach to purchase the security); and

f) In the case of rights offering or other special offerings, certain information to alert security holders.

2. Purpose for Making a Pre-Filing Announcement under Rule 135

a) In the case of an offering where the issuer already has equity securities currently traded, the existence of the proposed offering will often be material information.

b) In the case of an IPO, there is no legal need, but an announcement may end speculation and conjecture and may facilitate lining up selling stockholders.

c) In the case of an offering of debt securities:

(1) Sometimes the existence of the offering is material information; and

(2) Sometimes there is a desire to "notify" the marketplace in order to get "in line" on the debt offering calendar.

d) Underwriters generally prefer that announcements under Rule 135 not be made as they cannot be identified and the announcement alerts competitors to the deal being planned.

3. A Rule 135 announcement should be a stand-alone communication and should not be accompanied by an earnings announcement or new product release or any other announcement.

H. Public Announcements of Unregistered Offerings

1. Rule 135c[413] provides that a public announcement of a private placement or other unregistered offering (including a Rule 144A[414] offering or Regulation S[415] offering), similar to an announcement permitted by Rule 135, will not be deemed to be a prohibited "offer" under Section 5 (which would disqualify the private placement

[413] 17 C.F.R. § 230.135(c).

[414] 17 C.F.R. § 230.144A.

[415] 17 C.F.R. §§ 230.901 – 905.

under Regulation D[416]), provided that the announcement is not for any of the securities offered.

2. Rule 135c safe harbor is available to issuers who are Exchange Act reporting companies and to foreign issuers exempt from Exchange Act reporting pursuant to Rule 12g3-2(b).[417] If the safe harbor is used it must be filed on Form 8-K.

3. Rule 135e[418] provides that offshore press conferences, and offshore release of press materials, by foreign private or government issuers will not constitute an "offer" under Section 5 if following conditions are met:

a) The offering has a bona fide international tranche;

b) Foreign and U.S. journalists are provided equal access to the press conference and any materials distributed; and

c) Written materials distributed at the press conference:

(1) Contain a legend to the effect that such materials do not constitute an offering in the United States (as well as certain other information); and

(2) Do not contain any mail-in coupon or similar form that prospective purchasers can use to indicate their interest in the offering.

4. Rule 135e safe harbor applies even where there is a U.S. SEC-registered tranche in the offering. Safe harbor also extends to foreign private or government issuers, and their representatives (including underwriters and public relations firms), as well as to selling shareholders.

5. The safe harbor covers analyst reports distributed at such press conferences (even if Rules 138[419] and 139[420] reports would not be available).

6. Rule 135e safe harbor does not apply to offshore press conferences that are conducted by U.S.-based issuers. In order to qualify for safe harbor, press conferences must take place entirely offshore, and journalists in the U.S. may not participate via conference call or similar means.

7. Communications More Than 30 Days Before Registration Statement Is Filed

[416] 17 C.F.R. §§ 230.501 – 508.

[417] 17 C.F.R. § 240.12g3-2(b).

[418] 17 C.F.R. § 230.135e.

[419] 17 C.F.R. § 230.138.

[420] 17 C.F.R. § 230.139.

a) Rule 163A[421] provides that communications that are made by an issuer (but not any other offering participant, such as an underwriter) more than 30 days before the filing of a registration statement will not be "offers" for purposes of Section 5(c), subject to certain conditions.

(1) Communications cannot reference a securities offering that will be the subject of a registration statement.

(2) The issuer must take reasonable steps within its control to prevent further distribution or publication of such communications during the 30 days immediately preceding the date of filing the registration statement.

(3) Rule 163A is a non-exclusive safe harbor and issuers may claim the availability of any other applicable exemption or exclusion.

8. Regular releases of factual business information. If an issuer has previously released or disseminated factual business information in the ordinary course of its business, SEC rules provide that it may continue to do so at all points during an offering (including during the pre-filing period) and those communications will not be considered "offers" for purposes of Section 5(c).

a) To rely on the safe harbors provided by Rule 168[422] (for reporting issuers) and Rule 169[423] (for non-reporting issuers), the timing, manner and form in which the information is released or disseminated must be consistent in material respects with the issuer's similar past releases of information. In the case of reporting issuers (Rule 168), the issuer may also continue to release forward-looking information subject to the same general guidelines.

9. Short sales to be covered by underwriters or dealers from the offering are illegal.

XXIV. THE WAITING PERIOD

A. Under Section 5(c) offers to sell are permitted, but Section 5(b)(1)[424] prohibits transmitting any prospectus relating to a security with respect to which a registration statement has been filed unless the prospectus meets the requirements of Section 10.[425]

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421 17 C.F.R. § 230.163A.

422 17 C.F.R. § 230.168.

423 17 C.F.R. § 230.169.

424 15 U.S.C. § 77e(c).

425 15 U.S.C. § 77j.

B. Section 5(a) makes it unlawful to sell any security by a prospectus or to carry a security in interstate commerce for sale, unless a registration statement is in effect with respect to such security.

C. During the waiting period offers are permitted (orally or using a statutory prospectus or FWP), but sales are prohibited. During this period indications of interest or are obtained by underwriters from prospective purchasers, and information with respect to possible purchasers is used by the issuer in "pricing" the offer.

D. Section 2(a)(10)[426] provides that "the term 'prospectus' means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security except"[427] as follows.

1. Rule 134[428] provides that a "prospectus" does not include a notice that contains only items of information permitted by the Rule and contains the legends required by the Rule. Types of allowable information include:

a) Factual information about the issuer;

b) Pricing information on the security;

c) A brief description of the intended use of proceeds (provided that has been included in the filed registration statement);

d) Identities of participating underwriters, including their roles within the underwriting syndicate, and descriptions of the procedures they will use for the offering (including account-opening instructions);

e) Information about any directed share programs; and

f) The anticipated schedule of the offering.

2. "Tombstone" advertisements during the waiting period and the post-effective period may be published pursuant to Rule 134. Tombstone advertisements over the radio or television which comply with the provisions of Rule 134 are permissible.

3. A Rule 134 announcement should be a stand-alone communication and should not be accompanied by an earnings or new product press release or any other announcement.

E. Oral communications. Oral communications are permitted because they do not fall within the definition of a "prospectus" in Section 2(a)(10).[429]

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[426] 15 U.S.C. § 77b(a)(10).

[427] 15 U.S.C. § 77b(a)(10).

[428] 17 C.F.R. § 230.134.

[429] 15 U.S.C. § 77b(a)(10).

When oral communications are reduced to writing, however, they can become a FWP.

F. FWPs allow issuers and underwriters to make written offers, and otherwise communicate in writing about an offering with potential investors, outside of the statutory prospectus.

1. A "free writing prospectus" is defined in Rule 405[430] as any written communication used in the offer or sale of securities covered by a registration statement that constitutes an offer and is made by means other than a statutory prospectus. It may be in a traditional paper format or a graphic form.

2. Rule 164[431] provides that a FWP that meets the conditions of Rule 433[432] will qualify as a Section 10(b) prospectus and thus that its use after the filing of a registration statement will not violate Section 5(b).

3. Except for a WKSI, the issuer must have a registration statement on file in order to use FWPs.[433]

a) In the case of an IPO, the registration statement must include a price range before FWPs can be used. This requirement reduces the amount of time in which FWPs are an available option for those offerings.

4. There are no content restrictions for FWPs other than a required legend. Information in a FWP may go beyond (but may not "conflict with") the information in the prospectus that is part of the registration statement.

5. An issuer is required to file with the SEC any FWP that it has itself (as opposed to any other offering participant) prepared or used.

6. Any issuer information in an underwriter FWP must also be filed.

7. Underwriters and other offering participants aside from the issuer generally do not have to file their FWP unless they are distributing them broadly.

a) When FWPs are required to be filed with the SEC, that filing must occur by the date of their first use.

b) Certain FWPs do not have to be filed, including most electronic roadshows and preliminary terms sheets.

[430] 17 C.F.R. § 230.405.

[431] 17 C.F.R. § 230.164.

[432] 17 C.F.R. § 230.433.

[433] *See* Securities Act Rule 163 (17 C.F.R. § 230.163) (pre-filing offers by WKSIs).

c) Final terms sheets do not have to be filed until 2 days after all terms are finalized.

d) If a WKSI uses an FWP prior to filing a registration statement, then that FWP must be filed at the time the registration statement is filed.

8. Rule 433(d)(1),[434] provides that "filed" does not mean that the FWP will be part of the registration statement or subject to liability under Section 11.[435]

9. Where information in a FWP has not been included in the registration statement, that omission will not, in and of itself, constitute a material omission for Section 11 purposes.

10. A FWP must include a generic legend indicating that it relates to a registered offering and specifying where the related registration statement and statutory prospectus may be obtained.

a) For seasoned issuers and WKSIs, the legend must include the URL (or hyperlink) where the statutory prospectus may be found on the SEC's website (unless the FWP is accompanied or preceded by a copy of the statutory prospectus).

b) Unseasoned and non-reporting issuers (IPO's) must deliver a statutory prospectus to an investor (or provide an active hyperlink) prior to or with the FWP which that investor receives.

c) If a WKSI uses a FWP prior to filing the related registration statement, it must include a different legend as specified in Rule 163.

11. Issuers and underwriters must retain any prospectuses that were not filed with the SEC for three years from the initial bona fide offering of the securities to which the FWP pertains.

12. Rule 164 provides cure provisions for good faith failures to meet the requirements relating to filing, legending and retaining FWP.

13. There is no corresponding cure provision for good faith failure to "precede or accompany" when it is required.

14. Common Types of FWPs

a) Those transmitting required information, such as:

(1) Terms sheets

(2) Recent developments

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[434] 17 C.F.R. § 230.433(d)(1).

[435] 15 U.S.C. § 77k.

(3) Those involved in marketing the securities

(a) Summary sales documents or marketing points

(b) Electronic roadshows

(4) Those being used to manage publicity problems, such as:

(a) Errant emails

(b) Media articles

(5) Media FWPs

(a) As is the case for all FWPs (other than pre-filing ones which may be used by WKSIs only), the registration statement must be on file.

(b) Media FWPs must be filed within 4 days of the issuer or underwriter becoming aware of the publication (rather than on the date of first use, which might be unknown and out of the control of the issuer or any underwriters).

(c) The legend does not have to be included until the media FWP is filed with the SEC.

(d) There is no requirement that the statutory prospectus precedes or accompanies the media FWPs (even for non-reporting and unseasoned issuers).

(6) The filing obligation may be met by filing the actual media article, a copy of the article with corrections and clarifications noted, or a copy of all written information provided to the media.

(7) In order to qualify for the more relaxed rules, the media must be independent of, including not being paid by, the issuer or the underwriters. Special rules are available for issuers that are themselves in the media industry.[436]

(8) Media FWPs are a subset of media publications. Not all media reporting or stories are FWPs.

(9) A media publication based solely on information filed with the SEC or on other information the dissemination of which did not represent an offer by the issuer or other offering participant, where there is

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[436] *See* Securities Act Rule 433(f) (17 C.F.R. § 230.433(f)).

no involvement or participation by an offering participant, is neither an illegal prospectus nor a FWP.

b) Graphic Communications and Electronic Media

(1) Written communication is defined as "any communication that is written, printed, a radio or television broadcast, or a graphic communication."[437]

(2) Graphic communication includes "all forms of electronic media, including but not limited to, audiotapes, videotapes, facsimiles, CD ROM, electronic mail, Internet Web sites, substantially similar messages widely distributed on telephone answering or voice mail systems, computers, computer networks and other forms of computer data compilation."[438]

(a) Emails and other electronic communications, if offers, are FWPs.

(b) "Graphic communication shall not include a communication that, at the time of the communication, originates live, in real-time to a live audience and does not originate in recorded form or otherwise as a graphic communication, although it is transmitted through graphic means."[439]

c) Issuer websites. Information posted on an issuer's website may be either an offer (a FWP) or historical information that is not an offer.

d) A facts and circumstances analysis is used to determine whether a communication is an offer.

e) The SEC has also provided an express safe harbor in Rule 433(e) by which historical information on an issuer's website will not be deemed an offer as long as it is:

(1) Separately identified as historical information; and

(2) Located in a separate section of the issuer's website containing historical information only.

G. Roadshows (Live and Electronic).

1. Roadshows may be either "live" or "electronic."

[437] 17 C.F.R. § 230.405.

[438] 17 C.F.R. § 230.405.

[439] 17 C.F.R. § 230.405.

a) Live Roadshows

(1) Representatives of the issuer and any underwriters meet in person with prospective investors.

(a) Live roadshows are oral and were permissible communications during the waiting period.

(b) Live roadshows are not FWPs.

(c) The SEC has clarified that:

(i) As long as visual aids such as slides or whiteboards are not made separately available, they are also “oral” and may be used;

(ii) Handouts are permissible as long as they are collected at the end of the roadshow (attendees may not take the handouts with them);

(iii) Transmission to overflow rooms is okay as long as it is “live” (not recorded);

(iv) Live roadshows may be transmitted to other cities and more than one place at a time;

(v) Live roadshows may be transmitted by telephone or internet; and

(vi) Live roadshows may not be broadcast on radio or television if they are to retain their oral characterization.

b) Electronic Roadshows

(1) A roadshow that does not meet the requirements of live, in real-time, and to a live audience and that is graphically transmitted is an “electronic” roadshow, is a “graphic communication” and thus is a free writing prospectus.

(2) Prior no-action letters that governed the use of electronic roadshows have been withdrawn and no longer apply.

(3) Numerous prior restrictions have been removed.

(a) Electronic roadshows may be produced in a studio and edited.

(b) Electronic roadshows do not need to be recorded before a live audience or need to include Q&As.

(c) Investors may download the electronic roadshow and replay it multiple times.

(4) Electronic roadshows are a free writing prospectus.

(a) Unseasoned and non-reporting issuers must include an active hyperlink to the statutory prospectus in order to meet the requirement that the statutory prospectus precede or accompany any FWPs used by those categories.

(b) Although electronic roadshows are FWPs, they do not need to be filed with the SEC with one exception for equity IPOs.

(c) Any slides or "handouts" used during the electronic roadshow may not be made separately available or they will be considered FWPs in their own right and will have to be filed with the SEC.

(d) If the offering is an equity IPO by a non-reporting issuer, then an electronic roadshow must be filed unless a bona fide version is made broadly available to an unrestricted audience.

(i) It is considered a "retail" electronic roadshow.

(ii) It does not have to be the same electronic roadshow provided to institutional investors, but must cover the "same general areas of information."

(iii) It does not have to include the same management presenters or cover all of the same subjects.

(a) The version available to a restricted audience might include projections, for example, but the broadly available electronic road show would not need to have projections.

(iv) "Retail" roadshows must be available by the time any other version is first used.

2. Research Reports by Investment Banks (Underwriters)

   a) A research report may be:

      (1) A "prospectus" in violation of Section 5(b)(1)[440] or Section 5(b)(2);[441]

      (2) An offer during the pre-filing period in violation of Section 5(c);[442] and/or

      (3) A solicitation of an offer to buy or an inducement to purchase in violation of Regulation M.[443]

      (4) Rules 137, 138, and 139 provide that under limited circumstances publication of information, opinions, and recommendations with respect to securities to be offered and sold will not be deemed to constitute an offer to sell such securities for purposes of Sections 2(a)(10) and 5(c).

      (5) The restrictions of Rule 101[444] of Regulation M are not applicable to research reports that comply with Rules 138 and 139.

      (6) Rule 137[445] permits publication of information, opinions, or recommendations with respect to a security by a broker or dealer acting in the regular course of its business who does not propose to be a participant in the distribution (including in an IPO) and who does not receive any consideration in connection with the publication of such information from the registrant or other persons interested in the distribution.

      (7) Rule 138[446] permits publication of information, opinions, or recommendations by a broker or dealer in the regular course of its business with respect to non-convertible debt or non-participating preferred stock of

[440] 15 U.S.C. § 77e(b)(1).

[441] 15 U.S.C. § 77e(b)(2).

[442] 15 U.S.C. § 77e(c).

[443] 17 C.F.R. §§ 242.100 – 105.

[444] 17 C.F.R. § 242.101.

[445] 17 C.F.R. § 230.137.

[446] 17 C.F.R. § 230.138.

a reporting issuer that is current with its Exchange Act periodic reports and which proposes to file or has filed a registration statement covering equity securities or securities convertible into equity (or vice versa), even though such broker or dealer is or will be a participant in the distribution of such securities.

(8) Rule 138 is also available for research concerning a non-reporting foreign private issuer that either has had its equity securities traded on a designated offshore market for at least 12 months or has a $700 million worldwide public float.

(9) It is a condition to the use of Rule 138 that the broker or dealer have previously published or distributed in the regular course of its business research reports on the types of securities that are the subject of the report for which the safe harbor is invoked.

(10) Rule 139[447] permits a broker or dealer participating in a distribution of securities by a seasoned issuer, or by certain non-reporting foreign private issuers, to publish research concerning the issuer or any class of its securities if that research is in a publication distributed in the normal course of its business. Rule 139 also provides a safe harbor for industry reports covering certain other reporting issuers, if the broker or dealer complies with restrictions on the nature of the publication and the opinion or recommendation expressed in that publication.

(11) Rule 139 Issuer-Specific Reports

(a) The broker or dealer must publish or distribute research reports in the regular course of its business and the research report in question must not represent the initiation (or re-initiation) of research about the particular issuer or its securities. The publication of one prior report will satisfy this requirement.

(b) The issuer must qualify under one of the following two tests:

(i) The issuer meets the registrant requirements for use of Form S-3 or

[447] 17 C.F.R. § 230.139.

Form F-3, and the minimum float ($75 million aggregate market value of voting and non-voting common equity held by non-affiliates) or investment grade securities provisions for use of the respective form, and is current with its Exchange Act periodic reports;[448] or

(ii) The issuer is a foreign issuer that meets all of registrant requirements of Form F-3, other than reporting history provision of that form, meets the minimum float or investment grade securities provisions of that form, and has either:

(a) Securities which have been traded for a period of at least 12 months on a designated offshore securities market; or

(b) A worldwide public float of $700 million or more. The SEC has made clear that Rule 139 is available for such issuers' initial public offerings in the United States.

(12) Rule 139 Industry Reports

(a) Rule 139 also permits issuer research in "industry reports" (reports that include "similar information with respect to a substantial number of issuers in the issuer's industry or sub-industry, or contain a comprehensive list of securities currently recommended by the broker or dealer."[449])

(b) To qualify for this safe harbor, the issuer must be either a reporting issuer or a foreign private issuer meeting the tests above regarding issuer-specific reports.

(c) The analysis regarding the issuer or its securities can be given no "materially greater

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[448] *See* Proposed Amendments to Various Rules and Forms under the Exchange Act that Rely on NRSRO ratings, Securities Act Release No. 8940, (July 7, 2008).

[449] 17 C.F.R. § 230.139.

space or prominence in the publication than that given to other securities or issuers."[450]

(d) If sales or earnings projections are included for the issuer, they must have been previously published on a regular basis, and similar projections covering the same periods must also be included with respect to a substantial number of companies in issuer's industry.

(e) Research reports meeting the conditions of Rule 138 or Rule 139 will not constitute "offers" or "general solicitations or general advertising" in connection with Rule 144A offerings, nor will they be "directed selling efforts" or be inconsistent with the "off-shore transaction" requirements in Regulation S offerings.

(f) SROs Research Analyst Conflict Rules, with which all brokers and dealers must comply, are intended to mitigate conflicts of interest that research analysts may face in the context of a subject company that is also an investment banking client. In addition to specific disclosure requirements and limitations on analyst compensation and involvement in offerings, the rules also impose "quiet periods" during which firms involved in the offering may not publish research on the issuer or discuss the issuer during public appearances, such as on financial news programs.

(g) These "quiet periods" extend for 40 days following an initial public offering and 10 days after a follow-on offering, and apply to managers and co-managers of the offering. broker dealers who participate as underwriters or dealers in an initial public offering are subject to a 25-day quiet period.

(h) Research by a manager or co-manager of an offering is also restricted in the 15 days prior to and after the expiration or waiver of any lock-up agreements that follow the completion of the offering.[451]

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[450] 17 C.F.R. § 230.139.

[451] *See* NASD Rule 2711; NYSE Rule 472.

(i) Amendments pending.

H. Remedies for “Gun Jumping” Violations

1. Remedies and reactions to gun jumping violations include one or more of the following:

a) Delaying effectiveness

b) Rescission – buyer gets 1 year put

c) Adding so-called rescission risk factor to prospectus

d) Adding offending material to prospectus

e) Withdrawal from the offering of underwriter responsible for violations

f) Not selling to a person receiving the improper offer

I. Issuer directed shares or “directed share programs.”

1. Popular for IPOs because shares can be reserved for “friends and family.”

2. The form of the letter to a potential purchaser should comply with Rules 134 and 135 so as not to be a prospectus (including a FWP).

3. Reforms expanded the ability to use Rule 134 notices for directed share program communications.

4. Once the IPO registration statement includes a price range, a FWP may also be used to convey information in writing to program participants, but the FWP must comply with the conditions of use (i.e., providing the statutory prospectus, legending and filing or retaining).

5. There cannot be a sale prior to effectiveness and cash may not be committed.

J. Circulation of Preliminary Prospectus

1. Rule 418(a)(7)[452] provides that information as to distribution of a preliminary prospectus is usually requested by the SEC.

2. Rule 15c2-8[453] under the Exchange Act requires, among other things, that in the case of a non-reporting company, (i.e., an IPO) a preliminary prospectus be delivered “to any person who is expected to receive a confirmation of sale at least 48 hours prior to the sending of such confirmation.”[454]

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[452] 17 C.F.R. § 230.418(a)(7).

[453] 17 C.F.R. § 240.15c2-8.

[454] 17 C.F.R. § 240.15c2-8(b).

3. Under Rule 460,[455] circulation of the preliminary prospectus may be a factor in granting acceleration.

K. Recirculation of an Amended Preliminary Prospectus

1. Liability under Section 12(a)(2)[456] will attach based on the information that has been conveyed to the investor by the time of sale. Recirculating a preliminary prospectus would be one means of conveying information but it is not the only possible method.

2. Acceleration under Rule 460[457] the SEC may require recirculation as a condition of granting acceleration of effectiveness.

3. Rule 15c2-8[458] does not require recirculation but does require that the broker or dealer take reasonable steps to assure that a copy of the amended preliminary prospectus, promptly after the filing thereof, be provided to each person soliciting customers' orders, and that any person furnishing a written request for a prospectus receive the latest preliminary prospectus on file.

XXV. THE POST-EFFECTIVE PERIOD

A. Sales are permitted only once the registration statement is "in effect."

B. Access equals delivery.

1. Under Section 5(b)(2) it is unlawful to use the mail or interstate commerce to carry a security for the purpose of sale or delivery after sale unless "accompanied or preceded by a prospectus that meets the requirements of" Section 10(a).[459]

2. Rule 172[460] provides that a final prospectus will be deemed to have been delivered to investors as long as it has been filed with the SEC by the required filing date.

3. Securities as well as related confirmations and notices of allocations may be sent to investors after effectiveness of the registration statement without needing to be preceded or accompanied by the final prospectus as long as the prospectus has been filed by the applicable due date.

4. The SEC has not extended the "access equals delivery" model beyond the three areas covered by Rule 172:

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[455] 17 C.F.R. § 230.460.

[456] 15 U.S.C. § 77l(a)(2).

[457] 17 C.F.R. § 230.460.

[458] 17 C.F.R. § 240.15c2-8.

[459] 15 U.S.C. § 77j(a).

[460] 17 C.F.R. § 230.172.

a) Delivery of securities;

b) Confirms; and

c) Notices of allocations.

d) It only applies to final prospectuses.

C. Free Writing After Effectiveness

1. The Section 5(b)(1)[461] prohibition against using a prospectus that does not meet the requirements of Section 10 continues to apply during the post-effective period.

2. Section 2(a)(10)(a) provides that a communication sent or given after the effective date is deemed not to be a "prospectus" if a prospectus meeting the requirements of Section 10(a) is "sent or given" to the person to whom the communication is made prior to or at the same time as the communication.

3. Sales materials and other written communications can thus be freely used in the post-effective period if accompanied or preceded by a statutory prospectus.

4. If they are not preceded or accompanied by a final statutory prospectus, the writings will be free writing prospectuses and will have to fully comply with those rules.

5. In the context of a shelf registration, it does not appear that a base prospectus is a sufficient Section 10(a) prospectus.[462]

D. Prospectus Delivery Following an IPO

1. Delivery of a prospectus by a dealer (including an underwriter no longer acting as an underwriter with respect to the security involved in such transaction) during the 25 days after the effective date is required if the issuer was not previously an Exchange Act reporting company (90 days if the security is not listed on an exchange or quoted through Nasdaq).

2. Research reports not accompanied or preceded by a prospectus must comply with Rule 137, 138, or 139.

XXVI. FINRA REVIEW

A. FINRA regulates the conduct of participating members.

B. Section 15A(e)[463] of the Exchange Act

1. The rules of a registered securities association may provide that no member thereof shall deal with any nonmember professional, as

[461] 15 U.S.C. 77e(b)(1).

[462] *See* Securities Act Rule 430A(c) (17 C.F.R. § 230.430A(c)).

[463] 15 U.S.C. § 78o-3(e).

defined, except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.

a) The term "nonmember professional" includes:

(1) With respect to transactions in securities other than municipal securities, any registered broker or dealer who is not a member of any registered securities association, except such a broker or dealer who deals exclusively in commercial paper, bankers' acceptances, and commercial bills; and

(2) With respect to transactions in municipal securities, any municipal securities dealer (other than a bank or division or department of a bank) who is not a member of any registered securities association and any municipal securities broker who is not a member of any such association.

b) This provision shall not be so construed or applied as to prevent:

(1) Any member of a registered securities association from granting to any other member of any registered securities association any dealer's discount, allowance, commission, or special terms, in connection with the purchase or sale of securities; or

(2) Any member of a registered securities association or any municipal securities dealer which is a bank or a division or department of a bank from granting to any member of any registered securities association or any such municipal securities dealer any dealer's discount, allowance, commission, or special terms in connection with the purchase or sale of municipal securities.

(3) This above is true provided that the granting of any such discount, allowance, commission, or special terms in connection with the purchase or sale of municipal securities shall be subject to rules of the Municipal Securities Rulemaking Board adopted pursuant to Section 15B(b)(2)k.[464]

C. NASD Rule 2710(c)(2)(A)

1. “No member or person associated with a member shall receive an amount of underwriting compensation in connection with a public offering that is unfair or unreasonable and no member or

[464] 15 U.S.C. § 78o-4(b)(2)k.

person associated with a member shall underwrite or participate in a public offering of securities if the underwriting compensation in connection with the public offering is unfair or unreasonable."[465]

D. A no objections letter is needed from FINRA.

E. Filing Mechanics

1. COBRADesk

a) This is FINRA's electronic filing system.

b) A user must register with FINRA to get a password.

c) All information filed for review is deemed confidential.

F. Material to File

1. A FINRA Questionnaire to solicit relevant information should be filed.

2. Documents and information to be filed include:

a) SEC filings are treated as filings with FINRA;

b) Offering details and detailed information about the receipt of "items of value" in the 180-day period prior to the first required filing with FINRA; and

c) The final form of executed underwriting agreement.

G. When to File

1. Offerings Exempt from Filing

a) Offerings are exempt from filing when the securities are offered by a corporation, foreign government, or foreign government agency issuer which has:

(1) Investment grade unsecured non-convertible debt with a term issue of at least four (4) years;or

(2) Investment grade unsecured non-convertible preferred securities (except that equity IPOs are required to be filed).

b) Investment grade non-convertible debt securities and non-convertible preferred securities are exempt.

c) Shelf takedowns of securities registered on Forms S-3 or F-3 are exempt.

d) Rule 144A and other private offerings are exempt, as long as the securities offered are "restricted securities."

e) Tender Offers pursuant to Regulation 14D[466] are exempt.

[465] NASD Rule 2710(c)(2)(A).

f) Spin-offs are exempt.

g) Certain securities offered in M&A transactions are exempt.

2. Offerings Requiring a Filing:

   a) IPOs;

   b) Secondary and follow-on offerings;

   c) Registered debt offerings (unless debt is investment-grade rated);

   d) Mortgage and real-estate investment trust ("REIT") offerings; and

   e) All other offerings not exempt under the Rules.

3. When to File

   a) The filing requirements are:

      (1) No later than one business day after the documents are filed with the SEC; and

      (2) No sale of securities subject to the Corporate Financing Rule may commence prior to receipt of a "no objections" opinion from FINRA.

H. Underwriting Compensation and Arrangements

1. Important Definitions

2. Amount of Underwriting Compensation

3. Unreasonable terms and Arrangements

4. Lockup Restrictions

5. Proceeds Directed to an Underwriter

6. Definitions

   a) Affiliate – 10% control presumption

   b) Issuer – issuer, selling shareholders and their respective affiliates, officers, directors and employees

   c) Participating Member – includes FINRA member, any associated person of the member, any members of their immediate family and any affiliate of the member

   d) Review Period – 180 days before the first filing through effectiveness or commencement of sales

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[466] 17 CFR § 240.14d-1.

e) Underwriter and Related Persons – underwriter's counsel, financial consultants and advisors, finders, and any participating member and any other persons related to any participating member

I. Amount of Underwriting Compensation

1. NASD Rule 2710(c)(2)(B)

a) All items of value received or to be received from any source by the underwriter and related persons which are deemed to be in connection with or related to the distribution of the public offering.

2. Items of value include:

a) Discounts, commissions, financial and consulting advisory fee;

b) Stocks, options, warrants, and other equity securities, including debt securities convertible to or exchangeable for equity securities, received:

(1) For acting as private placement agent for the issuer;

(2) For providing or arranging a loan or services for the issuer;

(3) As an investment in a private placement made by the issuer; or

(4) At the time of the public offering.

3. Pre-Offering Compensation

a) Objective standard

b) 180-day look-back period

4. Undisclosed and Post-Offering Compensation

a) 90-day look-forward period

5. Date of Receipt of Securities

a) This is typically the closing date.

6. NASD Rule 2710(c)(2)(D) & (E) – Factors in Determining Amount of Permissible Underwriting Compensation

a) Offering proceeds may be used to determine compensation.

b) The amount of risk assumed by the underwriter and related persons may be used to determine compensation. This is related to the type of securities being offered and the type of offer being conducted, such as:

(1) “Firm commitment” vs. “best efforts”; and

(2) Initial vs. secondary offering.

7. Compensation is directly related to the amount of risk to be assumed by participating members and inversely with the dollar amount of the offering proceeds.

8. Five Exceptions from Underwriting Compensation (NASD Rule 2710(d))

a) Purchases and Loans by Certain Entities

b) Investments In and Loans to Certain Issuers

c) Private Placements with Institutional Investors

d) Acquisitions and Conversions to Prevent Dilution

e) Purchases Based On A Prior Investment History

9. Purchases and Loans by Certain Entities

a) These cover securities received in connection with private equity investments or loans by affiliates of members.

b) Affiliates must meet certain capital management requirements.

c) 25% limitation

10. Acquisitions and Conversions to Prevent Dilution

a) Securities acquired as a result of:

(1) A qualifying right of pre-emption;

(2) A stock-split or a pro-rata rights or similar offering; or

(3) A conversion of securities that have not been deemed by FINRA to be underwriting compensation.

11. Acquisitions and Conversions to Prevent Dilution

a) Purchased securities have the same terms as securities purchased by other investors (except for pre-existing contractual rights granted in connection with a prior purchase).

b) The purchase opportunity was given to similarly situated security holders.

c) There is no increase in percentage ownership of the class, except conversions and passive increases that result from another’s failure to exercise its own rights.

12. Purchases Based on a Prior Investment History

a) The amount of securities purchased did not increase the purchaser's percentage ownership of the same generic class of securities of the issuer or of the class of securities underlying a convertible security calculated immediately prior to the investment.

b) At least two prior purchases were made:

(1) At least 24 months before the filing date; or

(2) More than 180 days before the filing date.

13. Valuation of Underwriting Compensation

a) Valuation Discount For Securities With a Longer Resale Restriction

(1) A lower value equal to 10% of the calculated value shall be deducted for each 180-day period that the securities or underlying securities are restricted from sale or other disposition beyond the 180-day period of the lock-up restriction.

(2) Certain transfers are not permitted during the voluntary lockup.

J. Unreasonable Terms and Arrangements

1. Certain Underwriting Arrangements are per se unreasonable, such as:

a) Accountable expense reimbursements;

b) Compensation in connection with incomplete offerings subject to certain exceptions;

c) "Tail fee" arrangements longer than two years;

d) Right of first refusal longer than three years; and

e) Limits on terms of options, warrants and convertible securities.

K. Corporate Financing Rule – Lockup Restrictions.

1. A 180-day lockup after effectiveness or commencement of sales of the public offering applies to:

a) Unregistered securities acquired during 180 days prior to the required filing date or acquired after the required filing date and deemed to be underwriting compensation by FINRA; and

b) Securities excluded from underwriting compensation pursuant to five exceptions from underwriting compensation.

L. Corporate Financing Rule – Proceeds Directed to an Underwriter

1. Disclosure in the underwriting or plan of distribution section of the offering document should state:

a) That the offering is being made pursuant to the provisions of NASD Rule 2710(h); and

b) Where applicable, the name of the member acting as Qualified Independent Underwriter ("QIU") and that such member is assuming the responsibilities of acting as a QIU in pricing the offering and conducting due diligence.

2. NASD Rule 2720

a) If 10% of the next offering proceeds, not including underwriting compensation, are intended to be paid to participating members, compliance with NASD Rule 2720(c)(3) is required.

3. NASD Rule 2720(c)(3) – One of three criteria must be met:

a) A QIU recommends the floor or ceiling price for the debt or equity offering and engages in due diligence;

b) If it is an equity offering, a bona fide independent market exists as of the date of the filing of the registration statement and as of the effective date thereof; or

c) The offering is of investment grade securities.

XXVII. REGULATION M-A[467]

A. In January 2000, the SEC enacted Regulation M-A, which deregulates shareholder communications incident to most forms of business combination and takeovers, in order to reduce the disparities between different forms of transactions offering different types of consideration. Prior to the enactment of this rule, a prospective acquirer who proposed to exchange its securities for securities of a target (either in a friendly merger or hostile exchange offer) operated at a disadvantage to a bidder who offered cash. The acquirer who offered stock had to register its securities and could not commence its exchange offer until the SEC had reviewed the registration statement covering these securities and declared it effective.

1. The registration and review requirement added both uncertainty and delay to this process. In contrast, a cash bidder could consummate a cash tender offer, which only has to remain open for 20 business days, much more quickly. As a result, there was an incentive for a bidder to use cash instead of stock because the longer the period before the offer could be consummated, the more vulnerable the bidder was to a "disruptive" higher bid by a hostile third party.

[467] 17 C.F.R. §§ 229.1000 – 1016.

2. As part of Regulation M-A, the SEC enacted Rules 162,[468] 165,[469] 166,[470] and 425[471] under the Securities Act. Rule 162 reduces the incentive to use cash instead of stock by permitting an offeror to solicit tenders of securities in an exchange offer before a registration statement is effective as to the security offered, so long as no securities are purchased until the registration statement is effective.

3. Although, such an exchange bidder would still be required to distribute a preliminary prospectus to target shareholders, in effect cash and exchange offers can now be commenced at the same point and consummated equivalently provided the SEC reviews and declares effective the exchange offer's registration statement within the 20 business day period mandated by the tender offer rules.

B. Publicity and Gun-Jumping

1. Prior to the new rules, any announcement of an exchange offer by the bidder could be deemed to be gun-jumping, in violation of Section 5(c) of the Securities Act, unless a registration statement covering the offered securities had already been filed. This meant that an issuer had to file its registration statement before it could safely announce an exchange offer. In addition, written materials might violate the prohibition on the use of "free writing" under Section 5(b) of the Securities Act. These problems imposed disparities between securities and the cash bidders as well.

C. Under the Rule 165(a), an offeror of securities to be issued in a business combination may make an offer to sell, or may solicit an offer to buy, those securities beginning with the first public announcement of the transaction, so long as any written communication made in connection with, or relating to, the transaction is filed under the new Rule 425 and such prospectus contains a prescribed legend. Because Rule 165's exemption from the Securities Act’s gun-jumping rules is conditioned on an obligation to file all written communications with the SEC after the first public announcement of the transaction, it is still possible that an issuer could blunder and violate the Securities Act. The term "public announcement" is broadly defined in Rule 165(f)(3),[472] and an issuer who casually indicated its intention to make a tender or exchange offer could thus violate the Securities Act if it failed to file written communications released after this point.

1. Further, once the registration statement is filed relating to the proposed business combination, Rule 165(b)[473] provides that any

[468] 17 C.F.R. § 230.162.

[469] 17 C.F.R. § 230.165.

[470] 17 C.F.R. § 230.166.

[471] 17 C.F.R. § 230.425.

[472] 17 C.F.R. § 230.165(f)(3).

[473] 17 C.F.R. § 230.165(b).

written communication made in connection with, or relating to, the transaction will not constitute a Section 10 prospectus or other form of unlawful free writing (and thus need not comply with the disclosure requirements of Section 10 of the Securities Act), so long as the written communication is filed under Rule 424[474] or Rule 425 with the SEC and contains a prescribed legend. Anti-fraud liability under Section 12(a)(2)[475] of the Securities Act will, however, attach to these communications.

D. Proxy Rule Reform

1. A similar exemptive rule was adopted under the proxy rules, so that the offeror could begin at once to solicit proxies prior to filing a proxy statement. Under amended Rule 14a-12,[476] a proxy solicitation may now be made before shareholders are given a proxy statement if all proxy soliciting material is given to the SEC, and a definitive proxy statement is sent to shareholder at or before the time that they are given proxy or consent cards or forms.

E. Commencement of the Offer

1. Prior to the new rules, a bidder who disclosed its intention to make a cash tender offer was required to formally commence (or withdraw) the offer within five business days. The point of this rule was to minimize market uncertainty and preclude deceptive stock manipulation tactics. This rule has now been repealed. Bidders and targets may now communicate freely with shareholders undeterred by the threat that a statement may inadvertently trigger a tender offer (or force an embarrassing withdrawal of one that was never truly commenced).

2. The only restriction is that a letter of transmittal (or similar instructions on how to tender) may not be sent prior to commencement. This parallels the equivalent restriction under the proxy rules barring a proxy card being distributed ahead of the proxy statement.

F. To discourage attempts to manipulate the market through misleading announcements of intended tender offers, the SEC has adopted a new Rule 14e-8,[477] which makes it fraudulent for a person to announce a plan to make a tender offer if the person does not have a bona fide intent to launch the offer within a reasonable time period or lacks a reasonable belief that it will have the means to purchase the securities for which it has tendered.

G. Subsequent Offering Period

1. Under the new rules, a bidder may (but need not) tender for shares during a "subsequent offering period" that would follow the

[474] 17 C.F.R. § 230.424.

[475] 15 U.S.C. § 77l(a)(2).

[476] 17 C.F.R. § 240.14a-12.

[477] 17 C.F.R. § 240.14e-8.

date all conditions to its offer were satisfied and the bidder accepted the tendered shares. Shares would have to be purchased as they are tendered during this period, and corresponding tendering shareholders would not have withdrawal rights. The subsequent offer period could be as short as three business days and could be extended by the bidder up to a maximum period of 20 business days.

2. The purpose of this new period seems to be to permit the bidder to tender for the remaining shares once it has clearly acquired control in the initial tender offer. This would either allow the bidder to clean up the transaction, acquiring all remaining shares without the typical back-end merger, or to raise its level of ownership to the percentage level under state law (typically 90%) that enabled it to effect a short-form merger without a shareholder vote.

H. Rule 14e-5. Replacing old Rule 10b-13, new Rule 14e-5[478] similarly precludes (subject to certain exception) any purchase by a bidder, its affiliates, or advisors of the securities subject to a tender offer (or securities convertible or exchangeable into the same) other than pursuant to the offer. The rule applies from the time the tender offer is announced until the offer expires. During any subsequent offering period, purchases outside the offer would be permitted, so long as the form and amount of consideration are the same as that offered in the tender offer.

I. Disclosure Forms

1. Consolidating the forms and specific disclosure requirements for different types of business combinations, the SEC has adopted Regulation M-A as a new subpart of Regulation S-K.[479] It now sets forth the disclosure requirements for issuer tender offers, third-party tender offers and going private transactions. Former Schedule 13E-4[480] (used in "going private" transactions) and Schedule 14D-1[481] (used in third party tender offers) have been merged into the new Schedule TO. Schedule 13E-3[482] will still be used when a "going private" transaction is to be effected by a means other than a tender offer.

2. Tender offers to purchase in cash and proxy statements in cash mergers are now required to include a plain English summary term sheet that highlights in bullet point fashion the principal terms of the transaction.

3. The new rules and amendments relax these restrictions by permitting the dissemination of more information on a timely basis without triggering the need to file a mandated disclosure document.

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[478] 17 C.F.R. § 240.14e-5.

[479] 17 C.F.R. § 229.10 *et seq.*

[480] Issuer Tender Offer Statement.

[481] Tender Offer Statement

[482] Transaction Statement under Section 13(e) of the Securities Exchange Act and Rule 13e-3 Thereunder.

Under the new scheme, a complete disclosure document still must be provided before a security holder may vote or tender securities, but other communications regarding the transaction are permitted.

J. Impact of Amendments

1. This should permit more informed voting and tendering decisions. The content of communications is not restricted, but anyone relying on the new rules must file written communications relating to the transaction on the date of first use, so that all security holders have access to the information. In particular, the amendments permit more communications:

   a) Before the filing of a registration statement relating to either a stock merger or a stock tender offer transaction;

   b) Before the filing of a proxy statement (regardless of the subject matter or contested nature of the solicitation); and

   c) Regarding a proposed tender offer without "commencing" the offer and requiring the filing and dissemination of specified information.

2. The amendments also harmonize the various communications principles applicable to business combination transactions under the Securities Act, tender offer rules, and proxy rules. Confidential treatment of merger proxy statements is retained, but only under limited circumstances.

3. Under the new scheme, if parties to a transaction publicly disclose information beyond that specified in Rule 135, the proxy statement must be filed publicly. If a proxy statement is filed confidentially, but later the parties disclose information beyond Rule 135, then the proxy statement must be re-filed publicly.

4. Under the new rules, third-party or issuer exchange offers may commence as early as the filing of a registration statement, or on a later date selected by the bidder, before effectiveness of the registration statement. As a result, a bidder offering securities will not need to wait until effectiveness to commence an exchange offer.

5. Early commencement is not mandatory, but rather at the election of the bidder. A bidder may file a registration statement, wait for staff comments, if any, and then decide to commence its offer. Any securities tendered in the offer could not be purchased until after the registration statement becomes effective, the minimum 20 business day tender offer period has expired, and all material changes are disseminated to security holders with adequate time remaining in the offer to review and act upon the information.

6. A bidder need not deliver a final prospectus to security holders. Security holders may withdraw tendered securities at any time before they are purchased by the bidder.

XXVIII. CONFLICTS OF INTEREST

BB. Overview

1. There are essentially two types of conflicts of interest confronting firms in the financial services industry.
    a) Conflicts between a firm's own economic interests and the interests of its clients. In addition to direct firm-client conflicts, indirect conflicts of interest could involve the firm and a fiduciary acting as agent for the ultimate clients, e.g. business entertainment.
    b) Conflicts of interest between a firm's clients, or between types of clients, can place the firm in a position of favoring one at the expense of another.

CC. Conflicts of Interest in the Securities Industry

1. Principal transactions. A financial intermediary may be involved as a principal with a stake in a transaction in which it is also serving as adviser, lender, or underwriter, creating an incentive to put its own interest ahead of those of its clients or trading counterparties.
2. Tying. A financial intermediary may use its lending power to influence a client to use its securities or advisory services as well – or the reverse, denying credit to clients that refuse to use other (more profitable) services.
3. Misuse of the fiduciary role. Mutual funds managers who are also competing for pension fund mandates from corporations may be hesitant to vote fiduciary shares against the management of those companies, to the possible detriment of their own shareholders. Or the asset management unit of a financial institution may be pressured by a corporate banking client into voting shares in that company for management's position in a contested corporate action such as a proxy battle.
4. Board interlocks. The presence of bankers on boards of directors of non-financial companies may cause various bank functions, such as underwriting or equity research, to differ from arms-length practice. Director interlocks can compound other potential sources of conflict, such as simultaneous lending, advisory, and fiduciary relationships.
5. Spinning. Securities firms involved in IPOs allocated shares to officers or directors of client firms on the understanding of obtaining future business, creating a transfer of wealth to those individuals at the expense of other investors.
6. Investor loans. In order to ensure that an underwriting goes well, a bank may make below-market loans to third-party investors on condition that the proceeds are used to purchase securities underwritten by its securities unit.
7. Self-dealing. A multifunctional broker dealer may act as trading counterparty for its own fiduciary clients, as when the firm's asset

management unit sells or buys securities for a fiduciary client while its affiliated broker dealer is on the other side of the trade.

8. Front-running. A broker-dealer may exploit institutional, corporate or other wholesale clients by executing proprietary trades in advance of client trades that may move the market.

9. Other Conflicts Wholesale on Issues

    a) Misuse of private information. A bank may obtain certain material non-public information about a client.

DD. Conflicts of Interest in Retail Financial Services

1. Involuntary cross-selling. Retail clients may be pressured to acquire additional financial services on unfavorable terms in order to access a particular product, such as the purchase of credit insurance tied to consumer or mortgage loans.

2. Churning. A financial firm that is managing assets for retail or private clients may exploit its agency relationship by engaging in excessive trading, which creates higher costs and may lead to portfolio sub-optimization.

3. Inappropriate margin lending. Clients may be encouraged to leverage their investment positions through margin loans from the firm, exposing them to potentially unsuitable levels of market risk and high credit costs.

EE. Conflicts

1. Suitability. A conflict of interest exists between a firm's corporate finance role in raising capital for clients in the financial markets and its obligation to provide suitable investments for retail clients.

2. Stuffing. A financial firm that is acting as an underwriter and is unable to place the securities in a public offering may seek to allocate unwanted securities to an account over which it has discretionary authority.

3. Conflicted Research

    a) Provide unbiased information and interpretation to investors, both directly and through retail brokers and institutional sales forces;

    b) Assist in raising capital for clients in the securities origination and distribution process;

    c) Help in soliciting and supporting financial and strategic advisory activities centered in corporate finance departments; and

    d) Support various management and proprietary functions of the firm.

4. Laddering. Banks involved in initial public offerings may allocate shares to institutional investors who agree to purchase additional shares in the secondary market, thereby promoting artificial prices intended to attract additional buyers who are unaware of these private commitments.

FF. Information Barriers and Inside Information

1. In 1968, the SEC required Merrill Lynch to establish information barriers as a condition of settlement of an enforcement action against the firm for "tipping" inside information. Merrill Lynch, as lead underwriter for a pending offering of debentures by Douglas Aircraft Company, had learned from Douglas that the company was about to announce a revised estimate of its earnings; the new estimate would be substantially lower than previously predicted. The Merrill Lynch underwriters relayed the negative information to the firm's institutional sales department, which in turn gave it to several clients of the firm. Prior to Douglas publicly announcing its lower earnings, Merrill Lynch's customers sold a substantial number of shares of Douglas stock.[483]

GG. Information Barriers and Inside Information

1. After the Merrill Lynch decision, brokerage firms included information barrier procedures in their compliance manuals and written supervisory procedures ("WSPs").

2. Information barriers may never entirely stop the flow of inside information or prevent insider trading, but they may reduce the frequency of their occurrence.

3. In Slade v. Shearson, Hammill & Co.,[484] the firm's retail brokers were recommending the stock of Tidal Marine, a corporate client, at a time when the firm had allegedly received information that Tidal Marine was expected to suffer heavy financial losses. Shearson's information barrier prevented this nonpublic information from being given to its brokers, who continued to recommend the stock to customers.

4. The firm's customers, who bought stock on the firm's recommendation after Shearson had received adverse information, sued the firm under SEC Rule 10b-5,[485] claiming Shearson was under a duty to its customers not to recommend the stock.

5. Shearson contended that its information barrier gave it a legal defense against this charge.

6. The district court rejected defense, holding that, since Shearson had voluntarily entered into conflicting fiduciary relationships with retail customers and corporate clients, it could not recognize its duty to one while ignoring its duty to the other.

HH. SEC and SRO Regulations – Misuse of Material Non-public Information

1. There are a number of federal laws which require firms in the securities industry to have policies intended to prevent the misuse of material nonpublic information.

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[483] In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 8459, 52 SEC Docket 4 (Nov. 28, 1968), *aff'd* Exchange Act Release No. 9267, 44 SEC Docket 633 (July 29,1971).

[484] 79 F.R.D. 309 (D.C.N.Y. 1978).

[485] 17 C.F.R. § 240.10b-5.

a) Section 15(f)[486] of the Exchange Act requires every registered broker or dealer to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by such broker or dealer and its associate thereof.

b) Section 204A[487] of the Investment Advisers Act of 1940 requires every investment adviser to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by such investment adviser and its associates.

c) Rule 17j-1[488] under the Investment Company Act of 1940 requires investment companies to adopt a written code of ethics containing provisions reasonably necessary to prevent violations of Rule 17j-1's anti-fraud provisions. Examples of such provisions are as follows:

(1) A review of employee and proprietary trading, accomplished by maintaining watch lists and restricted lists, and reviewing employee and proprietary trading; and

(2) Procedures concerning proprietary trading when the firm is in possession of material, nonpublic information.

(3) "Rumor lists" may include issuers doing business with the investment bank and issuers involved in recently announced transactions or that are subject to rumors regarding a pending transaction.

2. Rule 10b5-1 under the Exchange Act

a) Rule 10b5-1(c)(2)[489] provides an affirmative defense to charges that a firm that buys or sells a security while in possession of material nonpublic information about the security or its issuer did not trade "on the basis of" such information (and therefore did not constitute insider trading) where the firm demonstrates that:

(1) The individual making the investment decision on behalf of the firm was not aware of information; and

(2) The firm implemented reasonable policies and procedures, taking into consideration the nature of the firm's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information.

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[486] 15 U.S.C. § 78o(f).

[487] 15 U.S.C. § 80b-4a.

[488] 17 C.F.R. § 270.17j-1.

[489] 17 C.F.R. § 240.10b5-1(c)(2).

(3) The Rule expressly provides that such policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the firm has material nonpublic information, or those that prevent individuals making investment decisions from becoming aware of such information.

b) Of the affirmative defenses, one of the most common is the use of a preexisting written plan that complies with the requirements of Rule 10b5-1(c). Such "Rule 10b5-1 plans" can allow an executive the flexibility to purchase or sell securities at a time when the executive is otherwise aware of material, nonpublic information.

(1) These plans have come under scrutiny in the past few years and the SEC has stated that it was going to be moving "aggressively" to investigate claims of insider trading.

3. Exchange Act Rule 14e-3[490] imposes a duty of disclosure under Section 14(e)[491] on any person who trades in securities which will be sought or are being sought in a tender offer while that person is in possession of material information which such person knows or has reason to know is nonpublic and has been acquired directly or indirectly from the offeror, from the issuer, or from an officer, director, partner, employee, or any other person acting on behalf of the offeror or the issuer.

4. Rule 14e-3(b)[492] provides an affirmative defense for any person other than a natural person that shows that an individual making investment decision on behalf of such person to purchase or sell any security described in Rule 14e-3(a),[493] or to cause any such security to be purchased or sold by or on behalf of others, did not know material, nonpublic information. In addition, such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that the individual(s) making investment decision(s) would not violate Rule 14e-3(a). The policies and procedures may include, but are not limited to, those who restrict any purchase or sale of any such security, those who cause any purchase and sale of any such security, or those which prevent such individual(s) from knowing such information.

5. NYSE Rule 92 prohibits firms from entering orders for proprietary accounts if the person responsible for entry of such an

[490] 17 C.F.R. § 240.14e-3.

[491] 15 U.S.C. § 78n(e).

[492] 17 C.F.R. § 240.14e-3(b).

[493] 17 C.F.R. § 240.14e-3(a).

order has knowledge of any particular customer's order on the same side of the market which could be executed at the same price. A person responsible for entering proprietary orders is presumed to have knowledge of a particular customer order unless the firm has implemented "a reasonable system of internal policies and procedures to prevent the misuse of information about customer orders by those responsible for entering such proprietary orders."

6. In July 2007, the SEC approved amendments to Rule 92[494] which permit institutional investors with an order over 10,000 shares and $200,000 in value to "trade along" with a member organization's proprietary order under that rule. This aligns Rule 92 with a class of customers that can trade along under the Manning Rule.
   a) As amended, member organizations can trade along with customer orders if the member organization periodically provides written disclosures to such customers and obtains prior affirmative written consent (which can be obtained either in writing or orally, with a written confirmation of such oral consent). The requirement for affirmative consent differs from the Manning Rule. NYSE Regulation will be issuing additional guidance concerning such disclosures.
7. Riskless Principal Trading
   a) As amended, Rule 92(c) adopts provisions similar to the Manning Rule permitting riskless principal transactions at the NYSE. Floor brokers cannot submit riskless principal transactions. Member organizations can now enter a proprietary order if the purpose of such order is to facilitate the execution, on a riskless principal basis, of one or more orders (the "facilitated order"), subject to the following:
      (1) It must be a riskless principal transaction (Rule 92(c)(1));
      (2) The firm must provide the facilitated order the same per share price as the principal order, exclusive of any markup or markdown, commission equivalent, or other fee (Rule 92(c)(2));
      (3) The firm must submit a report of the execution to the Front End System Capture ("FESC") and also submit an electronic report to the FESC reporting on the underlying orders to the riskless principal transaction (to be implemented in March 2009)[495] (Rule 92(c)(3))

[494] Order Approving Rule Change to NYSE Rule 92, Exchange Act Release No. 56017 (July 5, 2007).

[495] Notice of Immediate Effectiveness of Proposed Rule Change Relating to NYSE Rule 92(c)(3), Exchange Act Release No. 57682, 73 Fed. Reg. 22193 (Apr. 24, 2008).

(4) The firm must follow allocation procedures disclosed to customers, including that proprietary orders must yield to consenting customers (Rule 92(c)(4) and (5)). The firm must:

(a) Have written policies and procedures concerning riskless principal transactions;
(b) Allocate riskless principal orders to the underlying account within 60 seconds of execution; and
(c) Have supervisory systems in place to produce records sufficient to reproduce, in a time-sequenced manner, all riskless principal orders.

8. ISO Exemption
    a) As amended, Rule 92(d)(5) permits firms to send intermarket sweep orders (ISOs) to the NYSE without violating Rule 92(a), so long as the member organizations yield any executions of ISOs to existing customer orders that would have been required to be protected by Rule 92(a) (i.e., customer orders known at the time of ISO entry that could have been executed at the same price)
9. After-Hours Trading by Specialists
    a) As amended on July 18, 2007, specialists can now trade in securities in which they are registered after regular trading has closed, notwithstanding open customer orders on the Display Book. This exemption period begins two-and-one-half hours after the close of regular trading and ends 15 minutes before the opening of the security.
10. The Manning Rule (NASD IM-2110-2)
    a) The rule prohibits a member holding an unexecuted customer limit order from trading for its own account the security at prices that would satisfy the customer limit order, without executing the customer limit order.
    b) However, if the firm implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent non-market-making desks engaged exclusively in proprietary trading from obtaining knowledge of customer limit orders held at the market-making desk, those other proprietary non-market-making desks may continue to trade in a principal capacity at prices the same as, or inferior to, the customer limit orders held at the market-making desk.
    c) An effective system of internal controls must include policies and procedures that prevent each of the desks separated by information barriers from obtaining knowledge regarding orders or trading activity of the other desks.

11. NASD Rule 2111

a) The rule prohibits a firm that accepts and holds a customer market order from trading for its own account at prices that would satisfy the customer market order, unless the firm immediately thereafter executes the customer market order.

b) However, if a firm implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent non-market-making desks engaged exclusively in proprietary trading from obtaining any knowledge of customer orders held at the market-making desk, those other proprietary non-market-making desks may continue to trade in a principal capacity at prices that would satisfy the customer market orders held at the market-making desk.

II. Appropriate Information Barrier Procedures

1. The purpose of an information barrier is to control the flow of material nonpublic information within the firm and prevent those employees who trade in publicly held securities from gaining access to material nonpublic information that may be acquired or developed by other departments within the firm.

2. Barriers are intended to separate areas which routinely have access to inside information from areas that trade in or sell publicly held securities or provide investment advice regarding publicly held securities.

3. A firm may distribute to all employees a policy statement which:

a) Clearly defines who is covered, what is prohibited, and who is on which side of the wall;

b) Explains the terms "material" "nonpublic" "inside information" and "proprietary information";

c) Addresses the firm's commitment to legal prohibitions against insider trading;

d) Prohibits employees from disclosing material nonpublic information to anyone except on a "need to know" basis; and

e) Prohibits employees on the banking side from disclosing material nonpublic information to employees on the marketing side.

4. The firm may require all employees covered by the Chinese Wall policy to sign statements affirming annually that they understand and accept the policies and have complied with them in the preceding year.

5. Departments which normally acquire or develop materially nonpublic information may be physically separated from departments engaged in sales, trading, or research with respect to publicly traded securities.

6. The firm may require the use of code names or numbers to identify confidential projects, and require the use of such codes on all documents.

JJ. Crossing the Wall

1. Employees on the banking side of the Wall may occasionally need to disclose confidential information to an employee on the "public" side of the firm to obtain their advice. For this purpose, the firm may establish "wall-crossing" procedures and require that all disclosures follow the following guidelines:

a) Banking employees may be required to obtain the prior approval of senior supervising personnel and the compliance department before bringing a marketing employee across the Wall and disclosing any confidential information to him or her; and

b) The firm could designate certain heads of departments or other senior marketing personnel to be the persons who should be brought across the Wall when necessary, so that the firm may limit the number of marketing employees who may be tainted with confidential information.

KK. The "Watch List"

1. The Watch List or Grey List is a confidential list (i.e., not generally distributed within the firm) of issuers that is used by a firm to monitor sales, trading, and research activity including personal trading and trading in proprietary accounts.

2. Firms may place issuers on the Watch List when the firm first receives inside information regarding the issuer, e.g., when the firm signs a confidentiality agreement with a client or executes an engagement letter with regard to an investment banking assignment.

3. Firms may also place an issuer on the Watch List when unusual market activity, rumors, or other activities suggest that it may be appropriate to monitor marketing activities or that there has been a breach of the Chinese Wall.

4. Issuers on the Watch List need not be clients of the firm; for example, if a client has confidential plans to make a hostile bid for an issuer, the target issuer may be placed on the Watch List.

5. Placement of an issuer on the Watch List does not normally affect sales or trading in any security of the issuer or any research regarding the issuer. The firm may, however, reserve the right to restrict those activities in certain circumstances.

6. The legal or compliance department may break trades, or require liquidations of positions relating to a transaction that will soon be publicly announced, or halt the dissemination of research in order to avoid the appearance of questionable trading.

7. Issuers are usually placed on the Watch List before news of the transaction involving that issuer or the role of the firm in such

transaction becomes public. In order to avoid the possibility of tipping, the identities of the issuers on the Watch List are usually kept confidential and are not disclosed to any employee except employees in the compliance department or those persons who are designated to monitor the Watch List.

8. An issuer is normally removed from the Watch List when the firm determines that it is no longer necessary to monitor research, sales, and trading activities with respect to that issuer, or when the transaction or assignment involving that issuer becomes publicly known and the issuer is placed on the Restricted List.

LL. The Restricted List

1. A “Restricted List” is a list of issuers whose securities a firm and its employees are precluded from recommending or investing in for their own accounts.
2. Firms generally place issuers on the Restricted List after transactions concerning the issuer and in which the firm is involved are publicly announced.
3. A firm also places issuers on the Restricted List when the firm agrees to become an underwriter in a public offering of securities of an issuer, or when the firm accepts a managing underwriter’s invitation to be a member of a syndicate.
4. Firms may place an issuer on the Restricted List for 24 hours or longer after the firm has released material research opinions or significant investment recommendations, or reports with respect to that issuer or its securities.
5. The list is made generally available within the member organization.

MM. NYSE/FINRA Joint Statement Notice on Minimum Information Wall Requirements

1. Memorialization and Documentation. A firm’s information wall procedures must be formalized, organized, and compiled within a firm’s procedural/policy manual. A “hodgepodge” of internal memoranda, excerpts from employee manuals, and principals’ signatures indicating that they have performed various reviews will not suffice to meet memorialization requirements.
2. Documentation used must be sufficient to re-create actions taken with respect to information wall procedures. A firm must maintain documentation of its written policies and procedures as well as analyses and investigations of employees and trading in accordance with SEC recordkeeping requirements.
3. Employee Education and Training. Employees should be educated as to federal laws and regulations and the firm’s own policies and procedures relating to the use of material non-public information. Employee training should extend beyond those in sensitive areas to include secretarial and clerical employees.

Employee education and training should include at a minimum the following elements:

a) Provision of information. Firms generally distribute to all of their employees a memorandum defining “material non-public information” and setting out the legal and firm requirements for the handling of such information.

b) Signed Attestation. Each employee must sign at least once, and the broker dealer must keep on file, an attestation of his or her knowledge and understanding of such requirements. The broker dealer may require employees in sensitive departments (e.g., investment banking) to sign an attestation on an annual basis.

c) Continuing education. A broker dealer’s procedures must include some process to update employees as to new or revised requirements, and to continue their education and compliance with the requirements related to the use of material non-public information.

4. Restricted, Watch, and Rumor Lists. Documentation for the use of restricted and watch lists may include:

a) Written standards for placing a security on and deleting a security from such lists;

b) The date and time that the security was added to and deleted from the list;

c) The name of each contact person responsible for the action and the rationale for addition and deletion; and

d) Restrictions that are applicable to trading in, or other activities involving, the security.

5. Employee trading. Broker dealers limit certain types of trading by their employees.

a) In-house requirement for employee trading.

6. NYSE Rule 407. A broker dealer that executes transactions for an employee of another broker dealer should first obtain permission from the employing broker dealer, and should also send duplicate confirmations and statements to the compliance department of the employing broker dealer for review.

7. Walled-Off Areas. Firm employees that have access to material non-public information concerning issuers should not have authority to make sales and trading decisions regarding the securities of such issuers and should be walled off from communicating any non-public information to those that make such decisions.

NN. Walling-Off Procedures

1. All confidential information that is in hard copy form is:

a) Stored in locked offices, filing containers, or desks;

b) Labeled “confidential”; and

c) Maintained in files that are clearly labeled “confidential” and that identify persons having authority to obtain or open such files.

2. Access to computerized confidential information is restricted through passwords and other security measures.
3. Access to designated work areas is restricted.
4. Following meetings at which confidential information is discussed, special conference room clean-up procedures are used.
5. Employees, including support staff, are required periodically to agree in writing to comply with the firm’s confidentiality procedures.
6. Distribution of written materials containing confidential information is restricted on a “need-to-know” basis.
7. Prior approval by the compliance department is required for internal communication of confidential information across the information wall.
8. The compliance department maintains a written list of all employees who have been given confidential information.

OO. Wall-Crossing

1. The broker dealer should have procedures in place that allow one department to request information from another department without disclosing the purpose for the request. In circumstances where the request itself would tip the employee in research or sales, it may be necessary to bring a research or sales employee “over the wall” before making the request. The Compliance and/or Legal Department must be notified promptly of any “wall-crossing.” In instances where employees are brought over the wall, the broker dealer should document and maintain written records of:
    a) The name of the employee brought over the wall;
    b) The employee’s department;
    c) The date;
    d) The name of the issuer or issuers involved;
    e) The name of the person requesting that the wall be crossed; and
    f) The reason for bringing a particular employee over the wall if that reason is not apparent from the employee’s department affiliation.

PP. Surveillance of Proprietary and Employee Trading

1. The broker dealer’s procedures should specify the time period covered and frequency of any review of proprietary and employee trading, as well as the department or person responsible for the review. The procedures should require the reviewer to initial or sign a record reflecting the completion of the review. The broker dealer should establish an exception report to record pertinent details of any transaction by an employee or propriety account in a restricted list or watch list security.

QQ. The Joint SRO Report on Research Analysts Conflicts of Interest

1. In December 2005, FINRA and NYSE submitted to the SEC a "Joint Report on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules"[496] (SRO Report), including recommendations for rule changes
2. The report concluded that the SRO Rules have been effective in helping to restore integrity to research by minimizing the influences of investment banking on research analysts and promoting transparency of other potential conflicts of interest.
3. Evidence also suggests that investors are benefiting from more balanced and accurate research to aid their investment decisions.

RR. SRO Research Analyst Rules -- Definitions

1. Research Report
   a) A "research report" means a written or electronic communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision. Interpretative exceptions:
      (1) Reports discussing broad-based indicies that don't recommend or rate individual securities;
      (2) Reports on economic, market, or political conditions that don't recommend or rate individual securities;
      (3) Technical analysis of a sector, index, or industry;
      (4) Reports distributed to fewer than 15 investors; and
      (5) Internal communications.
   b) SRO Report Recommendations
      (1) Amend the definition of "research report" to exclude mutual fund and direct participation program sales material.
      (2) Codify the interpretative exceptions.
      (3) Create a limited exemption from the registration requirements for "research reports" produced by individuals whose primary job is something other than research.
2. Research Analyst
   a) A "research analyst" is "an associated person who is primarily responsible for the preparation of the substance of a research report or whose name appears on a research report."[497]
3. Public Appearance
   a) "Public Appearance" means any participation in a seminar, forum (including an interactive electronic forum),

[496] JOINT REPORT BY NASD AND THE NYSE ON THE OPERATION AND EFFECTIVENESS OF THE RESEARCH ANALYST CONFLICT OF INTEREST RULES (2005), www.nyse.com/pdfs/rajointreport.pdf.

[497] NASD Rule 2711(a)(6).

radio, television or print media interview, or other public speaking activity, or the writing of a print media article, in which an analyst makes a recommendation or offers an opinion concerning an equity security.

b) SRO Report Recommendation

(1) Codify an interpretation consistent with SEC Regulation Analyst Certification that the term "public appearance" applies only to appearances involving 15 or more separate investors and another exception that it excludes certain password-protected webcasts.

SS. SRO Research Analyst Rules – Restrictions on Investment Banking Relationships with research Department

1. The SRO Rules prohibit certain conduct to minimize the primary source of biased research: the influences of investment banking ("IB").

a) Research analysts may not be subject to the supervision or control of IB personnel.

b) Analyst compensation restrictions

(1) Analysts can't be compensated based upon a specific IB transaction or the analyst's contribution to IB.

(2) Compensation must be reviewed by a committee that reports to the Board and has no IB representation.

(3) Compensation must consider productivity and quality of research, accuracy of predictions, and ratings from clients, sales force, and peers.

2. Certain communications between research and non-research personnel must be intermediated.

a) Communication with IB

b) Communications with subject company

3. No promises of favorable research may be made by the analyst.

4. There is a prohibition on retaliation by those in investment banking for unfavorable reports as a result of research.

5. SRO Report Recommendations

a) Prohibit <u>any</u> pre-publication review by investment banking and other non-research personnel, other than legal and compliance, of a research report by investment banking personnel.

b) Extend the retaliation prohibition to all employees, not just those involved in investment banking activities.

6. The SRO Rules restrict research analysts from involvement in soliciting and marketing investment banking transactions.

a) Research analysts may not participate in the solicitation of IB business

b) Research analysts are prohibited from:

(1) Participating in a roadshow related to an investment banking services transaction.

(2) Engaging in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction.

c) Investment banking department personnel are prohibited from directing a research analyst to engage in sales and marketing efforts and other communications with a customer about an investment banking services transaction.

d) Research analysts are permitted to educate investors and internal personnel about an investment banking services transaction, provided such communications are fair, balanced, and not misleading.

TT. SRO Research Analyst Rules – Quiet Periods

1. The Rules include certain "quiet periods" during which research may not be published or distributed.

a) The manager or co-manager of underwriting can't publish research or make a public appearance for 40 days after the IPO or 10 days after secondary offering.

b) All others who participate as an underwriter or dealer in the IPO are subject to a 25-day quiet period.

c) The manager or co-manager can't publish or make a public appearance 15 days before or after a lock-up expiration or waiver.

(1) There is an exception for significant news or event.

(2) There is an exception for actively-traded securities in the case of a research report meeting the requirements of SEC Rule 139.[498]

2. SRO Report Recommendations

a) Unify the length of quiet periods after IPOs for all managers and participating underwriters and dealers.

b) Tie the length of the quiet period to the SEC's rules regarding publication and distribution of research, i.e., 25 days for listed companies.

c) Eliminate and/or reduce the quiet period after secondary offerings and lock-up agreements.

UU. SRO Research Analyst Rules – Termination of Coverage

1. Firms generally may not cease coverage without issuing a final report with a recommendation.

a) Notice of termination must be given.

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[498] 17 C.F.R. § 230.139.

b) The final report must be made available by usual means of dissemination.

c) The final report must be comparable in scope and detail to prior reports.

d) It must include a final recommendation unless impracticable.

VV. SRO Research Analyst Rules – Personal Trading Restrictions

1. Rules do not prohibit research analysts from owning stocks they cover, but there are restrictions on such ownership and trading.

a) Research may not purchase or receive certain pre-IPO securities.

b) Research may not trade a subject company's securities for 30 days before and until 5 days after the issuance of a research report or a change in ratings or price target.

(1) There is an exception for significant news or event.

(2) There is an exception for an unanticipated significant change in personal financial circumstances, with pre-approval by legal or compliance and proper recordkeeping.

c) There is an exception to prohibitions for registered investment companies under the Investment Company Act of 1940.

d) There is an exception for other investment funds which analyst or a household member has no discretion, as long as ownership meets the 1%/20% test.[499]

e) There is a possible exception for quantitative research models.

f) Analysts must divest pre-IPO shares or refrain from coverage.

g) Legal or compliance must pre-approve trades by supervisors of analysts.

2. SRO Report Recommendations

a) Expand the exceptions to the personal trading restrictions on analysts for investments in funds over which neither the analyst nor a household member has discretion, provided that:

(1) The analyst or household member is not made aware of the fund's holdings or transactions other than through periodic shareholder reports; and

(2) The analyst or household member owns no more than 1% of the fund's assets.

3. Create an exception from the personal trading restrictions for firms that wish to ban analyst ownership of stocks they cover.

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[499] NASD Rule 2711(g)(5)(B).

WW. SRO Research Analyst Rules – Disclosure Requirements for Financial interests

1. If a research analyst or members of his household have a financial interest in a subject company's securities, it must be disclosed.
2. If a member owns 1% or more of any class of common equity securities, it must be disclosed.
3. Any other material conflict of interest that a member knows or has reason to know at the time of publication or of a public appearance must be disclosed.

XX. SRO Research Analyst Rules – Disclosure Requirements for Receipt of Compensation

1. If an analyst has received compensation based upon IB revenues it must be disclosed.
2. If member or affiliate has:
    a) Managed or co-managed public offering in past 12 months it must be disclosed.
    b) Received compensation for IB services in past 12 months it must be disclosed.
    c) Expects to receive or intends to seek compensation for IB services in next 3 months it must be disclosed.
3. If a member has received non-investment banking compensation in past 12 months, it must be disclosed.
4. If a subject company is or has been a client in the past 12 months and services were provided, it must be disclosed.
5. If an analyst or person with influence knows an affiliate received non-IB compensation in past 12 months, it must be disclosed.
6. If a member or analyst has reason to know of an affiliate non-IB compensation or client relationship, unless set up adequate walls, it must be disclosed.
7. There is an exception if disclosures will reveal material non-public information.

YY. SRO Research Analyst Rules – Disclosure Requirements for Other Information

1. If a research analyst or household member is an officer or director of subject company, it must be disclosed.
2. If a member makes markets in a subject company's securities, it must be disclosed.
3. Other applicable disclosures exist (e.g., advertising rules, federal anti-fraud statutes).

ZZ.SRO Research Analyst Rules – Disclosure Requirements for Ratings and Price Charts

1. Research reports must define the meaning of each rating used and must be consistent with plain meaning.
2. Irrespective of individual ratings systems, each report must disclose the percentage of all "buy," "hold/neutral," and "sell"

ratings, and the percentage within each category the companies for which member has provided IB services within the past 12 months.

3. Research reports must include a price chart, plotting daily closing prices against assigned ratings and price targets for 3-year period.

4. If no ratings or price targets exist, price charts do not need to be included.

AAA. SRO Research Analyst Rules – Disclosure Requirements for Form of Disclosure

1. Requirements
    - a) Disclosures must be clear, comprehensive, and prominent.
    - b) Records of public appearances must be maintained.
    - c) Disclosures must attest to the adoption and implementation of supervisory procedures.
    - d) There is an exemption for small firms.
2. SRO Report Recommendations
    - a) Permit web-based disclosure of conflicts of interest, provided that the cover of a research report contains a prominent warning that such conflicts exist and directs the reader to a web address where details of the conflicts can easily be found.
    - b) Codify existing interpretations that set forth the disclosure requirements when distributing third-party research reports.

BBB. SRO Research Analyst Rules —Third Party Research

1. The SRO joint interpretive memos set forth the more limited disclosure requirements when distributing third-party (3P) research.
    - a) "3P research" can mean either affiliate research or independent 3P research.
    - b) It doesn't matter where or to whom the research is distributed.
    - c) It is not considered a distribution if a customer requests the research or pulls it down from a website, unless the research is from an affiliate.
    - d) The distributing member must include 4 disclosures, if applicable:
        - (1) Member ownership;
        - (2) Investment banking relationship;
        - (3) Market making; and
        - (4) Any other actual material conflict of interest.
    - e) 3P research need not disclose non-IB compensation, unless rises to actual material conflict.
2. Regulation AC.[500] The SEC adopted Regulation Analyst Certification ("Regulation AC") pursuant to which:

[500] 17 C.F.R. §§ 242.500 – 505.

a) A research analyst must certify in research reports prepared by her/him that the views expressed in the report accurately reflect her/his personal views;
b) Such research analyst must certify either that her/his compensation is not directly or indirectly related to the recommendations or views in the research report or that it is;
c) Such research report may not be distributed in the absence of such certifications;
d) Broker-dealers must make a record within 30 days after each calendar quarter in which a research analyst makes a public appearance, which record must contain certifications by the research analyst that the views expressed by her/him in all public appearances during the calendar quarter reflected her/his personal views when expressed and either that her/his compensation is not directly or indirectly related to the recommendations or views expressed in such public appearance or that it is; and
e) If such certifications in respect of public appearances are not made, the broker dealer must notify FINRA or NYSE and for 120 days thereafter must disclose in each subsequent report prepared by the research analyst that s/he did not provide such certifications.
f) The scope of Regulation AC is different from that of the SRO rules. Under SRO Rules the definition of "research report" includes only analyses of equity securities of individual companies or industries, while the definition in Regulation AC refers to all securities.

XXIX. LIABILITY AND DUE DILIGENCE

A. The Securities Act of 1933[501]

1. Section 11(a)[502] Liability

a) Liability for a material misstatement or omission contained in a "registration statement."

b) The plaintiff must have purchased securities in the offering or be able to "trace" shares to specifically to the offering.

c) The defendant is:

(1) A signer;

(2) A director;

(3) An accountant or other expert; or

[501] 15 U.S.C. § 77a *et seq*.

[502] 15 U.S.C. § 77k(a).

(4) An underwriter.

d) Reliance is only necessary if plaintiff acquired the securities after the earnings statement that covers the twelve months after the effective date.

e) Defenses

(1) The statute of limitations as established in Section 13[503] of the Securities Act has expired. A claim must be made:

(a) 1 year from the discovery of or the constructive knowledge of the misstatement or omission; or

(b) 3 years from the offering date.

(2) No causation exists.

(a) Other factors caused losses (market decline).

(3) Due diligence had been performed.

(a) Different standards exist for expertised and non-expertised portions of the registration statement.

(b) The defense is not available to the issuer but is available to officers and directors.

(c) The statements in question were not made on the authority of an expert.

(i) The underwriter or other defendant conducted “reasonable investigation;” and

(ii) Had “reasonable ground to believe and did believe” that there was no misstatement or omission.

(d) The statements were made on the authority of an expert (e.g., audit opinions, certain legal opinions).

(i) There is no duty for underwriters and others to investigate if they had “no reasonable ground to believe and did not believe” there was a material misstatement or omission

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[503] 15 U.S.C. § 77m.

(ii) The “Expert” Defendant (e.g., auditor):

(a) Conducted a “reasonable investigation”; and

(b) Had “reasonable ground to believe and did believe no material misstatement or omission.

(e) The WorldCom Decision

(i) An auditor “comfort letter” is not equivalent to an audit opinion and underwriters are not relieved of the duty to investigate.

(ii) “Red flags” heighten an underwriters’ duty to investigate.

(iii) No regulatory safe harbor exists for underwriters of offerings pursuant to shelf registration statements.

(iv) Assume the full duty applies and conduct as much investigation as possible before shelf take-down.

(v) Rule 176 factors used to determine whether there was a “reasonable investigation.”

2. Section 12(a)(2)[504]

a) Liability pertains to the “offer or sale” of a security.

(1) The purchase must be made in the offering.[505]

b) The security must be purchased through a prospectus or oral communication.

(1) Liability is not limited to the final registration statement.[506]

c) The prospectus or oral communication must contain an untrue statement or omission of material fact.

(1) Only information available at time of purchase can be taken into account.

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[504] 15 U.S.C. § 77l(a)(2).

[505] Alloyd Co. v. Gustafson, 53 F.3d 333 (7th Cir. 1995).

[506] *Cf.* Securities Act § 11(a) (15 U.S.C. § 77k).

d) The plaintiff must have been unaware of “truth” at time of purchase.

e) The defendant must have “offered or sold” the securities at issue.

(1) According to the SEC, the issuer is a “seller” in a firm-commitment underwriting.

f) Defenses

(1) Plaintiff was aware of the “truth” at the time of purchase.

(2) Due diligence

(a) The defendant did not know “and in the exercise of reasonable care, could not have known” of the untruth or omission.

(b) Per the WorldCom decision, the defendant has lower burden under Section 12(a)(2) than under Section 11(a).

(3) No causation exists. Per Section 12(b), this is the defendant’s burden.

(4) The statute of limitations of 1 year from the plaintiff’s knowledge or 3 years from the offering date has expired.

g) 12(a)(2) Elements

(1) “Purchase or sale” of securities must have occurred.

(2) A false or misleading statement must have been made or an omission of a material fact must have occurred.

(3) For claims based on material omissions, a duty to disclose must be established.

(4) Scienter must exist.

(5) Reliance must have occurred.

(a) Fraud on the market presumption of reliance

3. Section 15

B. The Securities Exchange Act of 1934[507]

1. Section 10(b)[508] and Rule 10b-5[509]

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[507] 15 U.S.C. § 78a *et seq*.

a) Rule 10b-5

(1) Elements

(2) Causation

(a) Transaction causation

(b) Loss causation

(3) Damages

b) Other Rule 10b-5 Issues

(1) No "secondary liability"

(a) "Substantial participation" exception

(b) "Scheme" liability exception

(2) Statute of limitations

(a) Two years after discovery

(b) Five years after alleged violation

2. Section 20(a)[510]

C. Strict Liability Regime

1. Liability is predicated on the materiality of a misstatement or omission.

2. No scienter is required.

3. Reliance is generally not required.

XXX. PURCHASE AND SALE OF INITIAL EQUITY PUBLIC OFFERINGS

A. General Prohibitions

1. NASD Rule 2790(i) – Definitions

a) Rule 2790[511] provides definitions for "beneficial interest," "collective investment account," "conversion offering," "family investment vehicle," "immediate family member," "investment club," "limited business broker dealer," "material support," "new issue," and "restricted person."

2. NASD Rule 2790(a) – General Prohibitions

a) Subject to certain exceptions, members and associated persons cannot:

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[508] 15 U.S.C. § 78j(b)(5).

[509] 17 C.F.R. § 240.10b-5.

[510] 15 U.S.C. § 78t(a).

[511] *See* Proposed Rule Change Relating to the Adoption of NASD Rule 2790 as FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) in the Consolidated FINRA Rulebook Exchange Act Release 58134 (July 16, 2008).

(1) Sell a new issue to accounts in which a restricted person has a beneficial interest;

(2) Purchase a new issue in an account in which the member or associated person has a beneficial interest; or

(3) Continue to hold new issues acquired as an underwriter, selling group member, or any other capacity.

3. NASD Rule 2790(b) – Preconditions for Sale

   a) Before selling a new issue to any account, a member must have obtained, within the twelve months prior to the sale, a representation from the beneficial owner or conduit (e.g., intermediaries such as banks, foreign banks, broker dealers, investment advisers) that the account is eligible to purchase new issues in compliance with this rule.

   b) Letters. Based on certain representations and compliance with the requirements of SEC Rule 17a-4(i),[512] a third party may provide recordkeeping services to its FINRA member clients, and the member clients would not be required to individually download and separately retain copies of documents required pursuant to Rule 2790(b).

   c) Members can use a third party to fulfill their obligations under Rule 2790, but remain responsible for compliance with the Rule's requirements. If a member uses a third party, it must ensure that it continues to comply with the recordkeeping requirements of the Rule.

   d) Members can use IPO Distribution Manager to submit new issue distribution information directly to FINRA.[513]

4. NASD Rule 2790(c) – General exemptions

   a) The restrictions under this rule do not apply to certain accounts or persons, including, but not limited to:

(1) Registered investment companies;

(2) Certain common trust or similar funds;

(3) Certain insurance company general, separate, or investment accounts;

[512] 17 C.F.R. § 240.17a-4(i).

[513] NASD, IPO Distribution Manager, NTM 04-20 (Mar. 2004), *available at* http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003216.pdf.

(4) An account in which a restricted persons' beneficial interests do not exceed in the aggregate 10% of the account;

(5) Certain publicly traded entities;

(6) Certain foreign investment companies;

(7) Qualified Employee Retirement Income Security Act ("ERISA") benefit plans, as long as a broker dealer is not the sole sponsor;

(8) State or municipal government benefits plans subject to state and/or municipal regulation;

(9) Tax exempt charitable organizations; or

(10) Church plans under Section 414(e)[514] of the Internal Revenue Code ("IRC").

5. NASD Rule 2790(d) – Issuer-directed securities

   a) The restrictions under this rule do not apply to certain specifically directly securities, to programs sponsored by the issuer or an affiliate that meet certain criteria, or to securities that are directed to eligible persons who are otherwise restricted under the rule as part of a conversion offering that complies with the standards of the governmental agency or instrumentality that has the authority to regulate the conversion offering.

6. NASD Rule 2790(e) – Anti-Dilution Provisions

   a) The restrictions under this rule do not apply to an account that meets the following conditions:

   (1) The account has held an ownership interest in the issuer, or a company that was acquired by the issuer within the past year, for one year prior to the offering's effective date;

   (2) The sale of a new issue to the account does not increase its interest in the issuer beyond what it held three months prior to the time the issuer filed the offering's registration statement;

   (3) The sale does not include any special terms; and

   (4) The new issue is not resold or otherwise transferred for three months after the offering's effective date.

7. NASD Rule 2790(f) – Stand-by Purchasers

[514] I.R.C. § 414(e).

a) The restrictions under this rule do not apply to the purchase and sale of new issues pursuant to stand-by agreements that satisfy the following conditions:

(1) The standby agreement is disclosed in the prospectus;

(2) The standby agreement is a formal written agreement;

(3) The managing underwriter represents in writing that it is unable to find any other purchasers; and

(4) Securities sold pursuant to the standby agreement are subject to a three month lock-up period.

8. NASD Rule 2790(g) – Under-Subscribed Offerings

a) A member acting as an underwriter with respect to an offering is permitted to place portions of the offering in its investment account when it is unable to sell that portion to the public.

9. NASD Rule 2790(h) – Exemptive Relief

a) FINRA may exempt, conditionally or unconditionally, any person, security or transaction for good cause shown if it finds that the exemption is consistent with the purpose of the rule, investor protection, and the public interest.

10. FINRA Rule 2790(j) – Information required to be filed

a) Members must use the book-running managing underwriter of a new issue to file:

(1) The initial list of distribution participants and their underwriting commitment on or before the offering date; and

(2) The final list of distribution participants no later than three business days after the offering date.

XXXI. UNDERWRITING AGREEMENTS

A. Overview

1. An "underwriting agreement" is an agreement between the issuer, any selling security holders, and underwriting syndicate pursuant to which underwriters agree to purchase stock from the issuer and any selling stockholders at an agreed price if certain specified conditions, representations, and warranties are met.

2. The agreement:

a) Documents the economic terms of the transaction;

b) Documents the underwriters' due diligence;

c) Sets forth closing requirements;

d) Sets forth circumstances under which underwriters can terminate their obligation to purchase the securities;

e) Contains indemnity provision; and

f) Is required to be filed with SEC.

3. Representations, warranties, indemnities, and opinions must cover information available at the time of sale, including issuer free writing prospectuses.

a) In the case of representations, warranties, and indemnities, also include electronic roadshows.

4. Basic Provisions of the Underwriting Agreement

a) Representations and warranties

b) Purchase and sale agreement

c) Closing conditions

d) Covenants

e) Indemnification and contribution

f) Termination provision

B. Representations and Warranties

1. Purpose

a) They are the basis for terminating the underwriting agreement.

b) They allocate risk among the parties.

c) They aid in due diligence.

C. Purchase and Sale Agreement

1. This establishes a contractual relationship between the parties.

2. The agreement includes payment and delivery mechanics.

a) It sets forth a price per security to be paid by the underwriters ("net price").

b) It establishes a closing date.

D. Closing Conditions

1. Closing conditions are conditions to the underwriters' obligation to buy securities from the issuer (and/or any selling shareholders).

2. They support due diligence through the delivery of opinions, comfort letters, and other documents.

E. Covenants

1. Issuer Covenants are the promises made by the issuer which go into effect after the agreement closes.

2. Lockups

a) Lockups restrict the issuer, its officers, directors, and key shareholders from selling or otherwise disposing of shares or securities convertible or exchangeable into shares for a specified period – typically 180 days.

b) They are intended to avoid an excess supply of securities in the market immediately after the offering.

3. Allocation of Expenses

a) Issuers typically pay all expenses other than the underwriters' out-of-pocket expenses.

F. Indemnification and Contribution

1. The issuer (and/or selling shareholder) agrees to indemnify the underwriters from damages resulting from material misstatements or omissions.

2. A similar indemnity is given by the underwriters which is limited to information expressly provided by the underwriter.

3. Indemnification is unenforceable, however contribution is permitted.

G. Termination Provision or "Market Out"

1. Permits underwriters to terminate their obligation to buy the securities if certain external events occur that affect the marketing of the securities, such as:

a) "Trading generally" on the NYSE, Nasdaq, or Amex, etc. has been suspended or limited; or

b) Any outbreak or escalation of hostilities, any change in the financial markets, or any calamity or crisis that, in the judgment of the representative, is material and adverse.

XXXII. REGULATION M[515]

A. Adopted by the SEC on March 4, 1997,[516] Regulation M replaced old SEC Rules 10b-6, 10b-6A, 10b-7, and 10b-21 under the Exchange Act.

1. Regulation M was adopted by the SEC to preclude manipulative conduct by persons with an interest in the outcome of an offering. It is prophylactic in nature and generally prohibits activities and

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[515] 17 C.F.R. §§ 242.101 – 105.

[516] *See* Anti-Manipulation Rules Concerning Securities Offerings, Securities Act Release No. 7400, Exchange Act Release No. 38363 (Mar. 5, 1997).

conduct that could artificially influence the market for an offered security. Regulation M consists of six rules. Rule 100[517] includes definitions of certain terms used in Regulation M. Rules 101 and 102 regulate bids for and purchases of securities in distribution (and certain related securities) by participants in the distribution as well as certain of their affiliates. Rule 101[518] regulates bids and purchases by underwriters, prospective underwriters and other distribution participants, and affiliates of such persons that fall within the definition of "affiliated purchaser." Rule 102[519] regulates bids and purchases by issuers, selling security holders, and their affiliated purchasers.

B. Definition of Distribution.

1. “Distribution," for purposes of Regulation M, is 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.

2. The factors defining "special selling efforts" and "magnitude" include: (1) the number and nature of roadshows in the United States; (2) the presence of substantial selling efforts outside the United States; (3) the number of QIBs or other offerees and investors in United States; (4) the size and proportion of the offering being sold into the United States; and (5) any selling concessions.

C. Regulation M Rule 101[520] Activities of Distribution Participants

1. Rule 101[521] of Regulation M governs the activities of distribution participants (other than issuers and selling security holders, whose activities are governed by Rule 102[522]) and their affiliated purchasers. More specifically, Rule 101 makes it unlawful for a distribution participant (defined as an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution) or its affiliated purchasers “directly or indirectly, to bid for, purchase, or attempt to induce any person to bid for or purchase”[523] the security in

[517] 17 C.F.R. § 242.100.

[518] 17 C.F.R. § 242.101.

[519] 17 C.F.R. § 242.102.

[520] 17 C.F.R. § 242.101.

[521] 17 C.F.R. § 242.101.

[522] 17 C.F.R. § 242.102.

[523] 17 C.F.R. § 242.100(b).

distribution during the distribution's "restricted period" as defined in Rule 100(b)[524] of Regulation M.

2. Length of Restricted Period. The restricted period generally begins five business days prior to pricing, or whenever the broker dealer becomes a participant, whichever comes later. It ends when the broker dealer's participation ends. However, if the subject security has an average daily trading volume ("ADTV") of at least $100,000 and the issuer's public float is $25 million or more, the five-business day standard is reduced to a mere one business day.

3. The SEC interprets "attempt to induce . . . to bid for or purchase"[525] very broadly. The term includes any "activity that causes or is likely to cause another person to bid for or purchase covered securities,"[526] and the prohibitions apply regardless of the intent of the distribution participant or affiliated purchaser; no proof of scienter is necessary to establish liability.

4. Regulation M prohibits both actual inducements and attempted inducements of bids or purchases of covered securities during the applicable restricted period. Indeed, it is irrelevant whether the activity induced or attempted to be induced during the restricted period (i.e., trading in the "aftermarket") occurs during the restricted period, after the restricted period, or not at all. However, any determination as to whether a violation of Regulation M has occurred ultimately will depend on the facts and circumstances of the distribution participant's activities and conduct.

5. Certain securities are exempt from Rule 101, including those with $1 million minimum ADTV and a public float of $150 million.

6. Rule 101 permits transactions that comply with Rule 103[527] (Passive Market Making) or Rule 104[528] (stabilization, penalty bid, and syndicate short covering transactions).

D. Reference Securities

1. The prohibition on purchases or bids during the restricted period applies not only to the subject security, but also to any reference security.

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[524] 17 C.F.R. § 242.100(b).

[525] 17 C.F.R. § 242.101(a).

[526] Review of Anti-Manipulation Regulation of Securities Offerings, Exchange Act Release No. 33924, 59 Fed. Reg. 21681, 21687 (Apr. 26, 1994).

[527] 17 C.F.R. § 242.103.

[528] 17 C.F.R. § 242.104.

2. A reference security is a security into which the subject security can be converted, exchanged, or exercised, or which, to a significant extent, determines the value of the subject security.

a) For example, if a convertible bond is being distributed, the underlying common stock is a reference security subject to the restrictions of Rule 101. (Subject and reference securities are called covered securities under Regulation M.[529])

b) Note that while common stock would be a reference security if a derivative, such as a right or warrant, were the subject security, the reverse would NOT be true.

(1) For example, if XYZ Corporation is issuing common stock, warrants of XYZ common stock are NOT reference securities, since the SEC believes they do not, by their terms, affect the value of the security being distributed. Derivative securities are generally not subject to trading restrictions when the underlying security is being distributed. The SEC seems to believe that it is difficult to manipulate the price of an underlying security by trading the derivative itself.

3. There are circumstances under which an instrument will be a reference security, even though it cannot be obtained through conversion of the subject security. For instance, if an equity-linked security is tied to the value of certain common stock, the common stock is a reference security even though there is no conversion feature.

E. Exceptions to Rule 101[530]

1. Exceptions to Rule 101 exist for:

a) Transactions involving government and municipal bonds, nonconvertible investment-grade debt and preferred stock, and registered investment company securities;[531]

b) Actively Traded Securities, which are securities with a worldwide reported average daily trading volume ("ADTV") of

[529] 17 C.F.R. §§ 242.100 – 105.

[530] 17 C.F.R. § 242.101.

[531] The SEC proposed amendments to remove the exceptions concerning investment grade nonconvertible and asset-backed securities that are rated by at least one NRSRO, and propose instead new exceptions for nonconvertible debt securities and nonconvertible preferred securities based on the "well-known seasoned issuer" ('WKSI') concept as well as those securities registered on Form S-3. *See* Proposed Amendments to Various Rules and Forms under the Exchange Act that Rely on NRSRO ratings, Exchange Act Release No. 58070, (July 7, 2008).

at least $1 million that are issued by an issuer whose common equity securities have a public float value of at least $150 million (pending amendments), (the "ADTV/Float Exemption").[532] ADTV may be calculated based on the two calendar months preceding the offering or on a 60-day rolling period, ending within 10 days of the pricing of an offering without a registration statement (e.g., Rule 144A offering).

(1) Importantly, for non-U.S. issuers engaged in an international distribution, ADTV and the public float are calculated based on the worldwide reported volume regardless of whether the non-U.S. exchange constitutes a designated offshore exchange as defined in Regulation S.[533]

(2) Because issuers and affiliates do not have the benefit of this ADTV/Float Exemption, distribution participants who are affiliates of an issuer (e.g., public universal banks or public broker dealers) will need to be out of the market for the applicable restricted period (beginning 1 or 5 days prior to pricing). This can present problems in certain foreign markets where the affiliated broker dealer is the principal market maker of the issuer's securities.

c) Odd-lot transactions;

d) The exercise of any option, warrant, right, or similar instrument during the restricted period, regardless of when it was acquired;

e) Unsolicited brokerage transactions and unsolicited purchases when acting as a principal;

f) Securities of domestic and foreign issuers eligible for an exemption from the Securities Act under Rule 144A[534] if sold to qualified institutional buyers ("QIBs"), and certain Regulation S[535] transactions;

g) Transactions in the subject security that are part of a basket strategy, if the basket is not used for manipulation—the subject security must be no more than 5% of the basket, which must contain at least 20 securities; and

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[532] 17 C.F.R. § 242.101(c)(1).

[533] 17 C.F.R. §§ 230.901 – 905.

[534] 17 C.F.R. § 230.144A.

[535] 17 C.F.R. §§ 230.901 – 905.

h) Unaccepted bids, and purchases that do not exceed 2% of the security's ADTV, are excepted from the rule, if the broker dealer maintains and enforces written policies and procedures designed to prevent violations. Once inadvertent transactions are discovered, subsequent *de minimus* transactions are NOT excepted.

F. Research

1. Research reports referring to covered securities can be distributed during the restricted period if they meet the conditions of Rules 138[536] and 139[537] of the Securities Act.

G. Regulation M Rule 102[538] – Activities of Issuers

1. Because of temptation, Regulation M prohibits issuers and selling security holders (mainly insiders) from supporting or raising the price of a security being distributed. This means they may not purchase or bid for a covered security, or induce others to do so.

2. Exceptions to Rule 102

a) Rule 102 contains some exceptions that are like those of Rule 101, including those for unsolicited purchases, transactions in Rule 144A securities, exercise of convertible securities, odd-lot transactions, and transactions in exempted securities. However, since issuers and selling shareholders do not play the same role in the market as intermediaries such as broker dealers, some of Rule 101's exceptions are not available to them. For example, issuers may NOT bid for or purchase the following:

(1) Actively traded securities of the issuer or an affiliate;

(2) Basket transactions involving a covered security; or

(3) Inadvertent (*de minimus*) transactions.

b) Regulation M exempts issuers and distribution participants from the restrictions on market activities of Rules 101 and 102 in Rule 144A offerings of securities where the distribution in the United States is made exclusively to QIBs or to non-U.S. persons. The exception applies to market activities in all jurisdictions, including the United States, in connection with Rule 144A eligible securities.Importantly, Regulation M does not exempt offerings that include non-

[536] 17 C.F.R. § 230.138.

[537] 17 C.F.R. § 230.139.

[538] 17 C.F.R. § 242.102.

QIBs such as institutional accredited investors. Often institutional accredited investors are excluded from U.S. distributions so that issuers and underwriters can avoid trading restrictions. This is especially the case where foreign issuers are engaged in a restricted ADS offering and the underlying common stock is trading on a home country market exchange.

c) Regulation M exempts distributions of straight investment grade debt securities, straight preferred securities, and asset-backed securities.[539] Trading in outstanding non-investment grade securities is not restricted during distribution of new non-investment grade securities unless all of the terms of both the existing and new securities are identical. The basis for this exception is that these securities trade principally on the basis of credit rating and so do not present opportunities for manipulation to the same degree as in other situations.

H. Regulation M Rule 103[540] – Passive Market Making

1. The liquidity of Nasdaq stocks can be adversely affected when market makers who are syndicate members suspend their normal activity during an offering because of Rule 101. Therefore, Regulation M contains Rule 103, which permits distribution participants to continue making markets in a Nasdaq stock that is the subject of an offering during the Rule 101 restricted period, but only on a passive basis.

2. Market makers involved in a distribution may not enter a bid or effect a purchase at a price that exceeds the highest independent bid on Nasdaq. ("Independent bids" are those placed by market makers who are not involved in selling the new issue.) In a falling market, when the last independent bid drops below that of a passive market maker, the passive market marker may maintain its bid until its purchases have reached or exceeded the lesser of two times the maximum order size for that security, or the passive market maker's remaining daily limit. At that point, the passive market maker must drop its bid to or below the highest independent bid.

3. In a rising market, a passive market maker may raise its bid when the best independent bid rises, but is not required to do so. Note that if there are no independent market makers (i.e., all the market makers in that security are involved in the distribution), passive market making is NOT allowed.

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[539] 17 C.F.R. § 242.102(d)(3).

[540] 17 C.F.R. § 242.103.

4. Daily Purchase Limit

    a) A passive market maker's daily purchase limit is the greater of 30% of its ADTV in the stock (as determined by FINRA) or 200 shares. Once a passive market maker's net purchases (purchases in excess of sales) for that day are more than its purchase limit, it must withdraw from the market for the rest of the day. However, a passive market maker who is close to the limit is allowed to execute any single order even though the daily limit would be exceeded.

        (1) For example, suppose a passive market maker's daily purchase limit is 10,000 shares and it currently has net purchases of 9,500 shares. It may purchase 1,000 shares at this point if it is a single order, even though it knows its total net purchases will exceed its limit. Of course, it must then withdraw from the market. The firm may not aggregate orders into a single transaction for purposes of evading the rule. Two 500-share tickets could not be combined into a 1,000-share transaction in the above example.

5. Contemporaneous Transactions

    a) If offsetting buy and sell orders are executed and reported within 30 seconds of each other, only the net purchase would affect a passive market maker's totals.

        (1) For example, assume orders are received from customers to sell 600 shares and buy 500 shares. A passive market maker with a purchase limit of 10,000 shares and net purchases of 9,500 could act as principal, buying 600 shares and selling 500 shares for its own account. As long as the trades were executed and reported within 30 seconds of each other, its net purchases would increase by only 100 shares, from 9,500 to 9,600, and it would still be under its purchase limit.

6. Offsetting Orders

    a) If a passive market maker receives a customer buy or sell order, but does not have a matching order(s) with which to offset, the market maker is allowed 15 minutes to locate an order to fill the other side of the transaction. The offsetting order may be for a customer or another market maker. Once the offsetting order is located, the two transactions must be executed and reported within 30 seconds. When interacting with other market makers, a passive market maker may hit another dealer's bid, but may not lift another dealer's offer.

I. Regulation M Rule 104[541] – Stabilizing

1. “Stabilizing” is defined 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. Stabilization requires the existence of an independent market.

2. By definition, stabilizing is a manipulative activity. However, the SEC considers its benefits (facilitating an orderly distribution) to outweigh its disadvantages. So stabilizing is a permitted manipulative activity as long as the SEC's rules governing it are followed. Specific prior notice of a stabilizing bid must also be made to FINRA; the request need not be in writing, but must be confirmed in writing no later than the end of the first day the bid was entered. A copy of the cover page of the preliminary or final prospectus or other offering document, which includes a “Notice of Stabilization” on the inside front cover, must accompany the notice.

3. Rule 104 of Regulation M tries to strike a balance between the desirability of an orderly distribution and the need to prevent manipulation of a new offering. Purchases by the syndicate that are not necessary to prevent or retard a decline in the security's price, or which have a manipulative purpose, are illegal. Also, stabilizing is not permitted in an at-the-market offering (an offering of securities other than at a fixed price).

4. Initiating a Stabilizing Bid. The maximum price at which a stabilizing bid may be initiated is the public offering price. However, a lower ceiling may apply depending on the level of independent sales or bids in the market.

5. Initiating stabilizing when the principal market is open. After the opening of quotes for the security in the principal market, stabilizing may be initiated in any market at a price no higher than the last independent transaction price for the security in the principal market if:

    a) The security has traded in the principal market on the day stabilizing is initiated or on the preceding business day; and

    b) The current ask price in the principal market is equal to or greater than the last independent transaction price.

    c) If either of the preceding conditions is not satisfied, stabilizing may not be initiated in any market after the opening of quotes in the principal market at a price higher than the highest current independent bid for the security in the principal market.

[541] 17 C.F.R. § 242.104.

6. Initiating stabilizing when the principal market is closed. When the principal market for the security is closed, the price at which stabilizing can be initiated is generally limited to the lower of the price at which stabilizing could have been initiated in the principal market at its previous close, or the last independent transaction or bid in the market on which stabilizing will be initiated.

7. Anyone entering a stabilizing bid must grant priority to any independent bid at the same price, regardless of the size of the independent bid. Once initiated, a stabilizing bid may be raised to match independent bids in the market. There can be only one stabilizing bid per market or market maker.

8. Disclosure and Notification. If a syndicate decides to stabilize, it must notify the market in which stabilizing will occur, and must disclose the purpose of the stabilizing bid to the person with whom the bid is entered.

9. Aftermarket Activities. The SEC has noted that certain aftermarket activities can have economic effects similar to stabilization, especially syndicate short covering purchases and the imposition of penalty bids. Rule 104 requires that syndicates engaging in either of these activities must notify the SRO for the principal market in which the security is traded.

10. The SEC has structured Rule 104 taking global markets into account. For example, the rule permits stabilizing bids to be carried over from one market to another, irrespective of the intervening changes in the independent bids or transaction prices in the security.

11. To accommodate cross-border transactions, the SEC permits stabilizing outside the United States during an offering in the U.S. without complying with Rule 104. However, the following conditions have to be met:

(1) There is no stabilizing in the U.S.;

(2) Stabilizing is not conducted above the U.S. offering price; and

(3) The foreign stabilization occurs in a country with regulations similar to U.S. rules (such as the U.K.).

12. Other provisions of the rule that take into account international transactions include the following:

a) Stabilizing bids may be placed in the currency of the market in which the bid is made; and

b) Rule 104 allows adjustments to stabilizing bids to account for fluctuations in exchange rates.

13. Rule 104 of Regulation M regulates the prices at which stabilizing bids may be made. Specific rules pertaining to stabilizing bids follow:

    a) Stabilizing bids may follow the independent market up or down; however, they cannot exceed the offering price.

    b) Stabilizing bids are entered as “one-sided quotes.” Only the bid side is shown with an identifier denoting the bid as a stabilizing bid.

14. The investing public must be informed of any stabilizing activity, either in the prospectus, if available, or in writing, at the time of a transaction. Such written notice usually is made on a customer’s trade confirmation.

15. Pre-effective Bids. Market makers may enter pre-effective bids on an issue before the offering’s effective date. They must give written prior notice of at least one day to FINRA and indicate if the bid will be converted to a standard stabilizing bid once the offering is effective.

16. Syndicate Penalty Bids. A penalty bid is to minimize sell-backs of public offering stock to the underwriters at the stabilizing bid. The penalty takes the form of a mandatory rebate of the selling concession the broker dealer or registered rep earned with the original placement on the public offering stock. The penalty applies to broker dealers and registered reps who sell-back orders, after buying at the public offering price, at the stabilizing bid. The penalty does not apply to customers. The syndicate manager must provide written notice of intention to impose a penalty bid before the start of the activity.

17. Syndicate Covering. The syndicate uses a cover bid to reduce a short position created in connection with the offering. This occurs when the syndicate is forced to purchase shares in the secondary market to fill orders at the public offering price because of strong interest, as described below. The syndicate manager must provide written notice of its intention to engage in syndicate covering transactions before the start of the activity.

18. The Green Shoe option[542] allows the underwriter to buy additional shares from the issuer to satisfy this demand. An additional amount of up to 15 percent of the total amount of shares covered in the issue’s registration statement may be purchased under similar terms and price as the original share.

[542] The green shoe option, known by its legal title as an “over-allotment option,” is so named because the first company to use it was the Green Shoe Manufacturing Company.

19. If there is no Green Shoe provision, overselling by the syndicate results in a net short position. The underwriters must then buy shares in the secondary market to fill these orders at the public offering price. All losses are distributed pro rata among the underwriters. The short position may be reduced by a syndicate cover bid, as identified above.

20. The SEC registration statement and the prospectus must disclose the existence of a Green Shoe option and the conditions under which the option will be exercised.

21. Recordkeeping. Information on penalty bids, syndicate covering bids and stabilizing activity must be kept in a file or in a separate retrievable format by the syndicate manager for three years.

22. Amendments

a) The SEC proposed an amendment to Rule 104[543] to require any person communicating a bid that is for the purpose of effecting a syndicate covering transaction ("syndicate covering bids") to identify or designate the bid as such wherever it is communicated.

b) The SEC also proposed to amend the rule to prohibit the use of penalty bids. A penalty bid allows the lead underwriter to reclaim a selling concession paid to a syndicate member if that member's customers sell their allocated shares in the immediate aftermarket.

J. Regulation M Rule 105[544] – Short Sales in Connection with an Offering

1. Rule 105 of Regulation M prohibits manipulative short sales in anticipation of a public offering. Rule 105 is designed to prevent short selling activities that artificially depress market prices which can lead to lower than anticipated offering prices.

2. Short sales cannot be covered with offered securities purchased from an underwriter or another participant in the offering if they occur during the shorter of:

a) The period beginning five business days before the pricing of the offering; or

b) The period beginning with the initial filling of such registration statement or notification on Form 1[545] and ending with the pricing.

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[543] *See* Amendments to Regulation M, Securities Act Release No. 8511, Exchange Act Release No. 50831, Investment Company Act Release No. 26691, 69 Fed. Reg. 75774 (Dec. 17, 2004).

[544] 17 C.F.R. § 242.105.

[545] Form S-1: Registration Statement under the Securities Act, SEC, http://www.sec.gov/about/forms/forms-1/pdf.

3. The intent of Rule 105 is to prevent traders from driving a stock's price down during the cooling off period so that they can cover by buying the stock on the effective date at a depressed offering price.

4. Rule 105 prohibits purchases on the effective date to cover short sales established within 5 days of the effective date.

5. One area of concern was the practice by some investors of short selling into an offering. Investors who felt that a new issue would not be successful would sell the stock short and then cover their positions with securities purchased from the underwriters.

6. The fixed-price nature of the offering would provide the short sellers with a free hedge and disrupt the orderly distribution of the securities. In response, the SEC created Rule 105 of Regulation M, which provides that securities from an offering cannot be used to cover short sales effected during a period beginning five business days prior to the pricing of the offering and ending with the pricing of the issue.

   a) If the pricing of the offering occurs within five business days of the filing of the registration statement, then Rule 105 applies from the filing date until the pricing of the issue. The rule does not apply to shelf-registered offerings or those not conducted on a firm-commitment basis.

7. Amendments

   a) The SEC recently amended Rule 105.[546] The amendments eliminated the covering element of the former rule by expanding the standard prohibiting covering a restricted period short sale with offered securities to now prohibit any purchase of an offered security for any reason, whether the intent is to cover the short sale or otherwise

   b) In response to comments received, the amended Rule 105 is applicable only to equity offerings, and contains a "bona fide purchase provision" that allows a restricted period short seller to participate in an offering. The amended rule also includes new exceptions concerning separate accounts and investment companies.

   c) The exception for separate accounts allows a person to purchase the offered securities in an account where there was a short sale in another account if decisions regarding securities transactions for each account are made separately and without any coordination of trading or cooperation among or between the accounts.

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[546] 17 C.F.R. § 242.105.

d) The exception for certain investment companies allows an investment company to participate in an offering if an affiliated investment company or any series of such investment company sold short during the restricted period.

K. Proposed Regulation M Rule 106[547]

1. The SEC proposed new Rule 106 to expressly would prohibit distribution participants, issuers, and their affiliated purchasers, directly or indirectly, from demanding, soliciting, attempting to induce, or accepting from their customers any consideration in addition to the stated offering price of the security.[548]

2. This new rule would expressly prohibit certain abuses that occurred in connection with IPOs, particularly those in the late 1990's and in other "hot issue" periods, such as conditioning or "tying" an allocation of shares in a "hot issue" on an understanding that the customer would buy shares in another, usually "cold," offering,[549] or on paying excessive commissions to the underwriter.[550] This proposal would also prohibit issuers, underwriters, broker dealers, and other distribution participants from accepting an offer from a prospective purchaser to pay additional consideration in order to obtain an allocation of offered shares

XXXIII. IPO ALLOCATION AND DISTRIBUTION PRACTICES – SYNDICATE PRACTICE

A. Syndicate Structure/Syndicate Roles

1. Bookrunner

a) The firm responsible for managing the transaction. The role includes documentation, providing valuation leadership, organizing the marketing program, sizing, pricing, and

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[547] *See* Amendments to Regulation M, Securities Act Release No. 8511, Exchange Act Release No. 50831, Investment Company Act Release No. 26691, 69 Fed. Reg. 75774 (Dec. 17, 2004).

[548] *See* Amendments to Regulation M, Securities Act Release No. 8511, Exchange Act Release No. 50831, Investment Company Act Release No. 26691, 69 Fed. Reg. 75774 (Dec. 17, 2004).

[549] An IPO is considered to be a "cold" offering when there is weak investor interest in the IPO shares. An IPO is considered to be a "hot" offering when investor demand significantly exceeds the supply of securities in the offering. Shares in hot offerings often trade at substantial premiums to the offering price.

[550] The Commission has stated that such activity involves possible violations of the antifraud and anti-manipulation provisions of the federal securities laws. *See* Short-Selling Practices, Exchange Act Release No. 9824, 37 Fed. Reg. 22796 (Oct. 25, 1972) (972 Interpretive Release); SEC v Credit Suisse First Boston Corp., No. 1:02DV 0090, 2002 WL 479836 (D.D.C. 2002), Complain ¶¶ 1, 6 (alleging violations of FINRA Conduct Rules 2110 and 2330 and Section 17(a) under the Exchange Act and Rule 17a-3(a)(6) thereunder, for encouraging customers to channel profits from hot IPOs via excessive brokerage commissions in order to receive such hot shares).

allocation. In large offerings, bookrunners sometimes divide responsibilities along regional lines.

2. Joint Lead Manager

    a) The firm sometimes given a platform in marketing and distribution to ensure it is fully committed to transaction.

3. Co-lead Manager

    a) A support role which includes some marketing responsibility.

4. Underwriters (Syndicate)

    a) A minor role for other relationship banks.

B. Underwriting Compensation

1. 15% Underwriting Fee

    a) This fee compensates underwriters for their underwriting commitment, covers expenses, and the costs of aftermarket stabilization.

        (1) It compensates the underwriting group for the risk of underwriting and the cost of aftermarket stabilization.

        (2) The selling syndicate does share in the underwriting fee.

2. 20% Management Fee

    a) A fee to managers only for structuring, organizing, and managing the offering.

        (1) The fee for managing the transaction.

        (2) Divided between lead manager and co-managers.

3. The selling syndicate (i.e., non-manager underwriters) does not share in the management fee.

    a) 65% Selling Concession

        (1) The commission to managers, syndicate members, and the selling group for placing the shares.

        (2) It compensates and motivates the sales force effort.

    b) Economic split

        (1) 100% jump ball with cap on lead manager.

        (2) There is a fixed economic split.

C. Breakdown of Allocation

1. 25% Retail

   a) Recognizes retail distribution capabilities of managers and syndicate members.

2. 75% Institutional Pot

   a) Jump Ball

      (1) Allows institutional investors to designate a sales commission to the manager of their choice based on their assessment of the quality of service of offered by each.

      (2) Motivates the managers to use their full resources in marketing the offering.

      (3) It is combined with a cap on the lead manager to provide an added incentive to co-managers.

   b) Fixed

      (1) Pre-split, guaranteed compensation for each manager.

D. Types of Institutional Pot – Equity Offering

1. Jump Ball or Competitive Pot

   a) It is designed to maximize the creation of pot orders by permitting/encouraging competition for sales credits among co-managers.

   b) Sales credits are supposed to be directed/allocated by the purchaser to the manager(s) according to the level of contribution to the consummation of an actual order.

   c) Jump ball portions generally vary between 60 and 70 percent of the total pot. The balance, or fixed portion, is usually split evenly among all managers, but also may be split unevenly accordingly to the issuer's wishes (e.g., pro rata equal the management fee split arrangement.).

2. Positives

   a) It creates competition among co-managers.

   b) Some co-managers may not sell anyway, so the lead manager deserves the majority of the pot for doing the work.

3. Negatives

   a) It dilutes team effort.

b) Co-manager sales people may make fewer calls due to their concern about not receiving a significant amount of the pot because:

(1) There exists normal gravitation to the book manager, especially for larger, more active underwriters;

(2) The book runner hogs orders by controlling allocations and attempting to limit designations away form its own sales force;

(3) The purchaser does not want to irritate the book manager by attempting to interfere with the allocation process; and

(4) Sales people focus inordinate amounts of time on accounts that might favor their firm allocation-wise, as opposed to a broader list of potential investors that may have a fundamental interest in owning the securities.

E. Capped Jump Ball

1. The issuer caps the lead manager's percentage of individual pot orders that it will receive, with the balance going to other managers (and/or underwriters/selected dealers).

2. There may or may not be a limitation on the maximum percentage that an institutional account can designate away from the management group.

F. Open Pot

1. 100% of the pot is typically jump ball and there may be no guaranteed minimum to any individual co-manager.

2. Positives

a) There is a major incentive for institutional salespeople of co-manager(s) who recognize the potential to receive a significant piece of the order, i.e., work performed will be rewarded.

b) In the case of a sole-managed transaction, it could allow the book runner to provide incentives to secure research and market from syndicate members.

3. Negatives

a) Designations may go to a dealer(s) as a soft dollar payment for work not done on the deal itself.

b) It may increase infighting between the book runner and co-managers.

G. Fixed Compensation

1. Sales credit compensation is pre-determined as a fixed percentage of the institutional pot.

2. Positives

a) It may encourage team work in some instances.

b) It may reduce infighting between the book runner and co-managers.

3. Negatives

a) It may encourage co-managers institutional sales forces to coast and do very little actual selling. This drawback is especially true in the case of a busy calendar environment where a firm's first priority will be to its own lead-managed business or business where focus and effort will knowingly result in incremental sales credits.

b) Individual managers can do no better or worse than their fixed percentage.

H. After-Market Activities

1. The Greenshoe is the underwriters' option to purchase from the issuer a specified number of additional shares (typically 15%).

a) The over-allotment option ("Greenshoe") was first used in 1963 for the Green Shoe Company.

b) The underwriters incur a short position by "overallocating" the deal by the amount of the Greenshoe.

(1) If the stock performs well, the Greenshoe will be exercised to cover the short.

(2) If the stock performance is weak, the syndicate will buy shares in the open market to cover the short (Greenshoe will not be exercised).

c) Pre-Stabilization in Volatile Markets

d) Aftermarket stabilization consist of:

(1) The naked short;

(2) Stabilization at issue; and

(3) Stabilization below issue.

XXXIV. IPO ALLOCATION STUDIES

A. History

1. In the late 1990s there was an IPO bubble.

2. On August 5, 2000, the SEC Market Regulation published the SEC Staff Bulletin #10 (Prohibited Solicitations and "Tie-in" Agreements for Aftermarket Purchases).[551]

3. In August 2001, in the In re *IPO Securities* litigation, an order was signed consolidating over 300 class action cases alleging illegal tie-in arrangements by underwriters of IPO's between 1998 and 2000. [552]

4. In January 22, 2002, the SEC settled with CSFB regarding IPO allocation practices.[553]

5. In August 2002, NASD released NASD NTM 02-55 requesting comment on a proposed new Rule 2712 and amendments to existing Rule 2710 to prohibit certain IPO allocation abuses.[554]

6. On April 28, 2003, there was an announcement of Global Settlement and Voluntary Initiative regarding allocations of securities in hot IPO's to corporate executives and directors.[555]

7. In May 2003, NYSE/NASD (FINRA) published the IPO Advisory Panel Report.

8. On September 15, 2003, NASD filed proposed amendments to Rule 2712 with the SEC.[556]

9. On October 1, 2003, the SEC settled with JP Morgan regarding IPO allocation abuses in violation of Rule 101 of Regulation M.[557]

10. In November 2003, NASD published NTM 03-72, which discussed amendments to NASD Rule 2712.

11. On August 4, 2004, FINRA filed amendment No. 2 to IPO amendments to Rule 2712 with the SEC.[558]

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[551] SEC Staff Legal Bulletin No. 10 (Aug. 2000), *available at* http://www.sec.gov/interps/legal/slbmr10.htm.

[552] MDCM Holdings, Inc. v. Credit Suisse First Boston Corp., 216 F. Supp. 2d 251 (S.D.N.Y. 2002).

[553] SEC Sues CSFB for IPO Violations; CSFB Will Pay $100 Million, Litigation Release No. 17327 (Jan. 22, 2002).

[554] NASD, Regulation of IPO Allocations and Distributions, NTM 02-55 (Aug. 2002), *available at* http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003492.pdf.

[555] Press Release 2003-54, SEC, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest between Research and Investment Banking, (Apr. 28, 2003), *available at* http://www.sec.gov/news/press/2003-54.htm.

[556] NASD, Request for Comment on Regulatory Approaches to Enhance IPO Pricing Transparency, NTM 03-72 (Nov. 2003), *available at* http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003067.pdf.

[557] SEC Sues J.P. Morgan Securities Inc. for Unlawful IPO Allocation Practices; J.P. Morgan Agrees to Settlement Calling for Injunction and Payment of $25 Million Penalty, Litigation Release No. 18385 (Oct. 1, 2003).

12. On December 9, 2004, the SEC proposed amendments to Regulation M.[559]

13. On December 20, 2004, NASD IPO Allocation and Distribution rules were published for comment by the SEC.[560]

14. On January 25, 2005, the SEC settled with Goldman Sachs and Morgan Stanley regarding IPO allocation practices.[561]

B. Jay Ritter and Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, Journal of Finance (August 2002).[562]

1. In the 1990s, issuing volume roughly doubled from 1990-1994 (to $20 billion/yr), then again from 1995-1998 (to $35 billion/yr), then yet again from 1999-2000 (to $65 billion/yr). It subsequently fell to $34 billion in 2001.

a) The article seeks to review different explanations for these patterns in issuing activity, underpricing, and long-run performance. It also includes a personal perspective.

(1) The authors believe time variation in these phenomena deserves more emphasis.

(2) They also believe the asymmetric information theories are unlikely to be the primary determinant of fluctuations in IPO activity and underpricing, especially the excesses of the Internet bubble period. Rather, they believe that the specific non-rational explanations and agency explanations will play a bigger role in the future research agenda.

2. IPO Pricing & Allocation

a) Underpricing is a persistent feature of the IPO market, and while cyclical, it may have increased in magnitude over time.

b) Theories Based on Asymmetric Information

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558 Notice of Proposed Rule Change for NYSE and NASD Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in IPOs, Exchange Act Release No. 50896 (Dec. 20, 2004).

559 Amendments to Regulation M, Securities Act Release No. 8511, Exchange Act Release No. 50831, Investment Company Act Release No. 26691, 69 Fed. Reg. 75774 (Dec. 17, 2004).

560 Notice of Proposed Rule Change for NYSE and NASD Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in IPOs, Exchange Act Release No. 50896 (Dec. 20, 2004).

561 Press Release 2005-10, SEC, SEC Sues Morgan Stanley and Goldman Sachs for Unlawful IPO Allocation Practices; Each Firm Agrees to Settlement Calling for Injunction and Payment of $40 Million Penalty, (Jan. 25, 2005), *available at* http://www.sec.gov/news/press/2005-10.htm.

562 Jay Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. OF FIN. 1795 (Aug. 2002).

(1) If the issuer is more informed than investors, rational investors fear a lemon problem in which only investors with worse than average quality are willing to sell. Evidence in favor of such signaling theories is mixed.

(2) If investors are more informed than the issuer, for example about the general market demand, then the issuer faces a placement problem. A realistic assumption is that investors are differently informed.

(a) A negative cascade may occur, in which investors fear will only receive full allocation if they happen to be among the most optimistic investors. If everyone desires the offering, they get rationed.

(b) An informational cascade may occur, in which investors attempt to judge the interest of other investors and only request shares when they believe the offering is hot.

(3) Bookbuilding has been argued to allow underwriters to obtain information from informed investors.

(a) Common evidence in favor of bookbuilding is the effect of revisions in offer prices during the filing period.

(b) However, the theory suggests that the information provided by one incremental investor is not very valuable when the investment banker can canvas hundreds of potential investors.

(c) Agency based theory is where the issuer is less informed, but relative to the underwriter, not to investors. To induce the underwriter to put in the requisite effort to market shares, it is optimal for the issuer to permit some underpricing, because the issuer cannot monitor the underwriter without cost.

3. Theories Based on Symmetric Information

a) Issuers underprice to reduce their legal liability—they are less likely to be sued if price is lower.

(1) Authors say leaving money on the table appears to be an ineffective way of avoiding subsequent lawsuits.

4. Theories Focusing on the Allocation of Shares

a) Increased attention has been placed on how IPOs are allocated and how their shares trade.

(1) Part of the reason is based on perceived unfairness on how shares are allocated.

b) Loughran and Ritter 2002[563] explore conflict of interest between underwriters and issuers and determine there is evidence of "spinning."

(1) Underwriters might intentionally leave more money on the table then necessary and then allocate these shares to favored buy-side clients.

c) Both the bookbuilding theory and the conflict of interest theory predict sluggish price adjustment. The final offer price is not fully adjusted from the midpoint of the file price range when underwriters receive favorable information.

5. Conclusion: The authors believe asymmetric information models have been overemphasized. It is not a matter of which model is right, but more of the relative importance of different models. There has been little empirical work attempting to quantify the relative importance of different explanations of underpricing. The authors argue that theories based on asymmetric information are unlikely to explain average first day returns of 65%. The authors believe future explanations will need to concentrate on agency conflicts and share allocation issues as well as behavioral explanations.

C. Shane Corwin and Paul Schultz, *The Role of IPO Underwriting Syndicates: Pricing, Information Production, and Underwriter Competition*[564]

1. The article studies syndicates for 1,638 IPOs from January 1997 through June 2002.

a) Strong evidence exists of information production by syndicate members.

2. Offer prices are more likely to be adjusted up (down) in response to positive (negative) information when the underwriting syndicate is less concentrated or has more co-managers.

a) Upward price revisions generally result in reduced underpricing, but after controlling for price revisions, no

[563] Tim Loughran & Jay Ritter, *Why Don't Issuers Get Upset About Leaving Money on the Table in IPOs?*, 15 REV. OF FIN. STUD. 413, (Mar. 2002).

[564] Shane Corwin & Paul Schultz, *The Role of IPO Underwriting Syndicates: Pricing, Information Production, and Underwriter Competition*, 60 J. OF FIN. 443 (Feb. 2005).

additional relation exists between syndicate structure and IPO underpricing.

3. Information from co-managers can be conveyed to the book manager in two ways:

a) Underwriters may relay information about market interest in an IPO directly to the book manager; or

b) Co-managers may convey information indirectly through conversations with the issuer, who then uses this information in negotiations with the book manager.

(1) Finding that syndicate structure affects both upward and downward price revisions suggests that co-managers relay information directly to the book manager in at least some cases.

4. Syndicate members also provide analyst coverage and market-making services in the aftermarket.

a) Each additional co-manager in a syndicate results in one additional market maker.

b) Also each additional co-manager results in 0.8 additional analysts issuing reports in the three months after an IPO.

c) The number of non-managing syndicate members is not significantly related to either analyst coverage or market making in the aftermarket.

5. Additional evidence on the importance of analyst coverage comes from the probit model estimates[565] of the determinants of syndicate participation:

a) For large IPOs, having a top-ranked analyst in the issuer's industry significantly increases the likelihood that an underwriter is included in a syndicate either as a co-manager or in a non-managing role.

b) Geography is a significant determinant of syndicate participation. Underwriters are more likely to be included in a syndicate if they are in the same state as the issuer.

(1) This suggests that local underwriters are better able to market an issue to local investors or may be better equipped to assess demand from these investors.

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[565] Shane Corwin & Paul Schultz, *The Role of IPO Underwriting Syndicates: Pricing, Information Production, and Underwriter Competition*, 60 J. OF FIN. 443, 458 (Feb. 2005).

c) The single strongest determinant of whether an underwriter is included in a syndicate is participation in recent syndicates led by the same book manager.

(1) Almost as important is whether the book manager participated in recent offerings managed by the syndicate member.

(2) Thus, underwriter relationships are critical.

(3) Pichler and Wilhelm (2001)[566] note that syndicate members are required to exert effort that may be difficult to observe, resulting in potential agency problems.

(4) Ongoing relationships may reduce these agency problems in syndicates. The importance of relationships suggests that syndicate members are expected to play an active role in selling IPOs, determining IPO value, or providing aftermarket services.

d) Results suggest that issuers benefit from including more underwriters and particularly more co-managers in the IPO syndicate.

e) However, syndicate size may be limited for several reasons.

(1) Prestigious book managers and co-managers demand sizeable share allocations in order to participate in an IPO syndicate.

(a) Thus, syndicate size may be limited by the size of the offer and the choice of book manager.

f) Being a co-manager in the IPO significantly increases an underwriter's chances of becoming the book manager in follow-on offerings.

(1) As a result of this competition, book managers may actively discourage the inclusion of additional co-managers.

g) The importance of existing underwriter relationships may further limit the set of potential syndicate members.

h) At least for small IPOs, we find that underwriting spreads increase as the number of co-managers in the syndicate

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[566] Pegaret Pichler & William Wilhelm, *A Theory of the Syndicate: Form Follows Function*, 56 J. OF FIN. 2237 (Dec. 2001).

increases. The authors note that their results may not apply to IPO syndicates from other periods.

6. During the relatively short sample period of the study, the nature of IPO syndicates changed.

a) Syndicate size decreased significantly from 1997 to 2002 even as offer proceeds increased.

b) Over the same period, the mean number of co-managers per offer rose.

c) Many smaller underwriters disappeared during our sample period, while the proportion of IPOs underwritten by the largest investment banks increased.

d) These patterns are consistent with those documented by Chen and Ritter (2000)[567] and Ljungqvist and Wilhelm (2003)[568] and suggest that the importance and functions of underwriting syndicates may be changing over time.

D. Alexander Ljungqvist, Felicia Martson and William Wilhelm, *Scaling the Hierarchy: How and Why Investment Banks Compete for Syndicate Co-Management Appointments* (September 29, 2005)[569]

1. The paper addresses whether when a bank pressures its analysts to provide aggressively positive assessments of issuing firms (common in 1990s) it improves a bank's chances of being appointed co-manager, which might open the door to more lucrative lead management appointments.

a) Such behavior led to penalties and structural reforms impose under the Global Settlement[570] to diminish ties between investment banking and research.

b) Findings in article support this conjecture.

2. Data

a) The study used all debt and equity offerings by US issuers between 12/1/93 – 6/30/02 (when new rules by NASD and NYSE for sell-side analysts went into effect).

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[567] Hsuan-Chi Chen & Jay Ritter, *The Seven Percent Solution*, 55 J. OF FIN. 1105 (June 2000).

[568] Alexander Ljungqvist & William Wilhelm, *IPO Pricing in the Dot-Com Bubble*, 58 J. OF FIN. 723 (Apr. 2003).

[569] Alexander Ljungqvist et al., *Scaling the Heirarchy: How and Why Investment Banks Compete for Syndicate Co-Management Appointments* (Sept. 29, 2005) (Financial Institutions Research Group Working Paper Series, Paper No. S-FI-05-02).

[570] The Global Settlement is an enforcement agreement reached on April 23, 2003, between the SEC, NASD, NYSE, and ten of the United States' largest investment firms to address issues of conflict of interest within their businesses.

b) The study only included deals lead by one of the 50 largest underwriters (by market share) during the year of the offering.

3. Providing coverage has a strong positive effect on a bank's chances of being appointed a co-manager.

a) Ahead of equity transactions, the likelihood of becoming co-manager increases from 2.3% to 17.3% when the bank provides research coverage, which is consistent with the idea issuers "buy" analyst coverage with co-management appointments.

b) Aggressive recommendations or upgrades diminish chances of being appointed a co-manager for equity offerings, but improve chances of being co-manager for debt offerings.

c) Evidence exists that aggressive recommendations among co-management candidates served their interests in pursuit of equity deals when the lead manager was a commercial bank.

d) Also, banks that attract an issuer's co-management appointments are more likely to win more lucrative lead-management mandates in the future.

(1) Experience improves chances of winning more lucrative lead management mandates, even when issuer has an exclusive relationship with a bank.

(2) Thus, aggressive analyst behavior appears to have played some role in attracting co-management appointments.

e) Results also suggest a potential unintended anti-competitive effect that might arise from the Global Settlement's separation of research and investment banking.

(1) If separation of these functions compromises the ability to compete for co-management appointments via analyst coverage, this provision of the Settlement has potential for bearing most heavily on marginal competitors fighting to climb the securities underwriting ranks.

4. Underwriting syndicates' lead manager's influence over co-management decision.

a) The findings confirm Corwin and Schultz 2005's conclusions[571] regarding the importance of reciprocity in the selection of syndicate managers.

(1) Candidate banks are more likely to become co-manager when they have participated more actively in the lead bank's recent syndicates and when the lead bank has participated more actively in recent syndicates led by the co-management candidate.

E. John Asker and Alexander Ljungqvist, *Sharing Underwriters with Rivals: Implications for Competition in Investment Banking*, (December 6, 2005)[572]

1. The authors investigate how informational frictions create a different constraint on competition in investment banking—the need to maintain exclusive client relationships to avoid information leakage.

a) Collectively, three tests in this study suggest that an issuing firm's concerns about information leakage are at least as important as its existing bank relationships and bank reputation in determining the identity of the lead manager in a given debt or equity deal.

b) A less conservative view, based on authors' third test, would suggest that this is a lower bound and that concerns about information leakage may be many times more important than any other previously documented effect.

c) Issues relationships with investment banks: why do issuers typically maintain strong relationships with one investment bank?

(1) Authors argue that the results help explain why issuers typically maintain strong relationships with one investment bank.

(a) With a limited number of banks capable of executing large or complex deals, there simply may not be enough banks to allow each company in a given industry to have multiple relationship banks while at the same time avoiding sharing banks with its major rivals.

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[571] Shane Corwin & Paul Schultz, *The Role of IPO Underwriting Syndicates: Pricing, Information Production, and Underwriter Competition*, 60 J. OF FIN. 443 (Feb. 2005).

[572] John Asker & Alexander Ljungqvist, *Sharing Underwriters with Rivals: Implications for Competition in Investment Banking* (Dec. 6, 2005) *available at* http://www.usc.edu/schools/business/FBE/seminars/papers/F_12-2-05_LJUNGQVISTcompete.pdf.

(b) Documentation shows a stunning shift away from exclusive bank-firm relationships during the 1990s.

(i) This suggests that entry by commercial banks has played an important role in loosening the constraint imposed by information leakage concerns since deregulation began in 1988.

d) How competition among investment banks is viewed?

(1) Results suggest that the position of incumbent banks is not quite as strong as was previously thought.

(a) Relationships are not everything and issuing firms are keen to maintain relationships with multiple banks so long as there is little risk sensitive information is disclosed to a rival.

(i) This is good news for entrants that have the capacity to handle complex deals.

(b) Similarly, banks that merge are unlikely to retain clients in industries where the merger results in rivals sharing an underwriter.

(i) The probability of losing at least one such client is over 80% following such mergers.

e) Choice of Underwriter

(1) Evidence suggests that firms' underwriter choice is more constrained than was previously thought.

(a) Concerns about information leakage appear to reduce the effective choice set of lead managers enjoyed by an issuing firm.

(b) This would dampen the pressure of competition among banks, in the absence of a competitive shock such as a merger or entry.

(c) This may be a part of the reason so little price competition is observed in the underwriting market.

f) Supply Side of the Industry

(1) The study examined demand for underwriting services and drew implications for the nature of competition from the estimated structure of demand. To better understand the competitive nature of investment banking, and as a result the way capital markets are accessed, it is also necessary to consider the supply side of the industry.

(2) In particular, a rigorous empirical understanding of the production function underlying investment banking would go a long way to fleshing out the appropriate competitive model of investment banking.

(3) This was no small task, since the capital and labor used in production in this industry are meshed together in the minds of banks' employees.

(4) Thus the first place to start would be to unravel the returns to, and market for, bankers at different stages of their careers.

(a) This requires investment in datasets of a quite different nature than that used in this study.

F. M. Nimalendran, Jay R. Ritter and Donghang Zhang, *Are Trading Commissions a Factor in IPO Allocation?* (October 20, 2004)[573]

1. This study[574] examines the impact of the discretionary power underwriters have in the distribution of shares of initial public offerings ("IPOs"), which is inherent in the book-building process, on the trading commissions paid to underwriters by investors.

2. The authors further attempt to determine whether the practice of allocating shares in hot IPOs to investors for the purpose of inducing them to direct commission business to the investment banking firm in return was pervasive.[575]

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[573] M. Nimalendran et al, *Are Trading Commissions a Factor in IPO Allocation?* (Working Paper, U. of Fl., Oct. 20, 2004).

[574] The study used the trading volume of the 50 most actively traded stocks for each trading day based on the rank of a stock's average trading volume for the past 20 days to capture IPO-related trading. It excludes stocks with high volatility or a price of below five dollars. It examined 3,499 IPOs during a sample period from 1993 to 2001. It aggregated the money left on the table by IPOs by offer dates, and obtained a time series of the daily amount of money left on the table. With controls for market movements, a time trend, and calendar-related patterns in trading volume, it employed an autoregressive model with four lags to study the relationship between the trading volume of the 50 liquid stocks and the amount of money left on the table by the IPOs.

[575] According to the study, "Evidence from regulatory settlements indicates that investment banks have allocated IPOs partly on the basis on trading commissions. For example, the January 22, 2002 [SEC] settlement with [Credit Suisse First Boston] …(CSFB) states that CSFB allocated hot IPOs to some clients and in return received commissions of up to 65% of the profits (money left on the table)."

a) The study hypothesizes that the trading volume of large liquid stocks is linked to the money left on the table by IPOs.[576]

b) The authors looked specifically at three methods of "IPO-related trading"– trading by investors with the sole or partial purpose of generating commissions to affect future IPO allocations.

(1) The first method, stock churning, is non-economic trading with commission generation as the only purpose.

(2) Investors also engaged in excessive portfolio rebalancing and timed the trading around IPO dates or

(3) They moved routine trading (economic trading that is incurred for non-IPO-related reasons) that is not timing-sensitive to take place around IPO dates.

3. To achieve the desired end of generating commissions, several strategies may have been employed to structure the IPO-related trades to minimize any adverse regulatory or market impact.

a) One mechanism employed was to simultaneously submit buy and sell orders for the identical block of stock with two different securities firms.

b) Another involved trading fewer shares, but paying an abnormally high commission per share.

c) However, for almost all conceivable strategies, trading highly liquid stocks would be preferred, both to minimize bid-ask spreads and price impacts costs, and to avoid the attention that would come from trading large blocks of a less liquid stock.

4. The results of the paper indicate that hot IPOs on the current day or a few days later are associated with higher current day trading volume if money is left on the table.

5. It further indicates that IPO-related trading, which includes stock churning, the timing of excessive portfolio rebalancing and regular trading around IPO dates, is linked to money left on the table by IPOs.

[576] The study uses the Securities Data Company's new issues database to identify IPOs from 1993 to 2001. All unit offerings, American Depository Receipts, Real Estate Investment Trusts, and closed-end funds are excluded. The study also excluded banks and savings and loans (SIC 6020-6120 and 6712) and all IPOs with an offer price of less than 5 dollars. The Center for Research in Security Prices database was used to check the IPO offer date and first-day closing price. The New York Stock Exchange's Trade and Quote database was used to calculate trading volume.

6. Additionally, the authors conclude that the practice of allocating shares in hot IPOs for the purpose of generating commissions was not limited to the few IPOs and investment banks as revealed in the regulatory investigations, but was in fact widespread.

G. Reena Aggarwal, *Allocation of Initial Public Offerings and Flipping Activity* (April, 2003)[577]

1. This paper analyzes the "flipping activity"[578] of investors and how this activity correlates with certain aftermarket activities, describes the process by which underwriters use to allocate shares and the procedures by which they track flipping activities, reaffirms its analysis with data pertaining to allocation and flipping activity and concludes with its empirical findings.

a) Underwriters perform many different functions in the IPO process.

(1) They begin by doing due diligence and examining every aspect of the issuing company.

(2) The underwriter also arranges a roadshow, whereby the offering is priced. During the roadshow, the investment bank starts to build a book and gets a sense of the demand for the offering and the type of investors interested in buying it.

(a) During the roadshow, potential investors give the underwriter a sense of how to price the issue and whether to revise the filing range. As for investors, this period gives them a chance to assess their position with regards to the IPO.

(i) For example, an allocation of only 50,000 shares may be too small for the portfolio of a large mutual fund – as a result, the fund manager may either buy more shares in the aftermarket or choose to unload the initial allocation for a quick profit.

b) It is important for investment banks to keep track of flipping activity by investors because the immediate reselling of the shares can push the stock price downward in weak offerings.

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[577] Reena Aggarwal, *Allocation of Initial Public Offerings and Flipping Activity*, 68 J. OF FIN. 111 (Apr., 2003).

[578] "Flipping" is the term used when shares are sold in the immediate aftermarket by investors who receive an initial allocation at the offer price; it does not include purchases in the aftermarket.

(1) Although not necessarily true for hot IPOs because of the commissions generated from frequent trading, weak offerings that experience extensive flipping activity create selling pressure that can lower the price well below the offer price.

(2) As a consequence, the underwriter is forced to "stabilize" the stock price by buying flipped shares in the aftermarket.

(a) Investment banks penalize flippers by excluding them from future deals or by imposing penalty bids[579] because of the possibility of such downward selling pressure.

c) The author of this paper used the Securities Data Company ("SDC") New Issues database to identify all IPOs that took place during the period May 1997 to June 1998.

(1) During this period, there was a total of 617 IPOs issued.

(2) For each offering, the data includes both the allocation of shares between retail and institutional clients and information on the flipping activity of retail and institutional investors.

(3) Therefore, one is able to deduce how many retail and institutional clients originally bought shares then sold them in the aftermarket during the first 30 days.

d) Upon examining the trading volume during the first two trading days of an IPO, the author finds that original investors generally hold onto their shares.

(1) Put another way, a large proportion of trading volume is not due to flipping by investors who were initially allocated shares at the offer price.

(2) However, the small percentage of flipped shares is traded several times, resulting in high volume. This means that the high volume did not result from the sale of a large proportion of issued shares, but rather from the repeated buying and selling of the same shares.

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[579] In a penalty bid, the lead underwriter takes away the commission paid to a syndicate member for selling shares (part of the gross spread) that were flipped by its customers. Each syndicate member receives a selling concession based on the number of shares it sells/distributes. If the syndicate member's customer flips their shares, then the selling concession on those shares is forfeited and credited back to the lead underwriter. The syndicate investment bank in turn takes the commission away from the broker who sold the shares.

(3) Also, the volume of trading between market makers such as wholesalers adds to trading volume.

e) The proportion of IPO shares allocated to institutions is, on average, 73.33%.

(1) On average, the lead underwriter sells 62.47% of the offering and allocates 81.86% of its shares to institutions.

f) The paper also discusses how flipping activity correlates to the filing range.

(1) 25 IPOs were priced below the amended filing range, 48 IPOs were priced above the filing range, and 120 were priced within the filing range.

(2) IPOs priced below the filing range have a mean initial return of 7.42% and IPOs priced above the range have a mean initial return of 28.39%.

(3) IPOs priced below the filing range had a trading volume (as a percentage of shares offered) of only 44.13%.

(a) In contrast, IPOs priced within the filing range had a trading volume of 82.71%, and IPOs priced above the filing range 99.80%.

g) The data also indicates that flipping accounts for a smaller proportion of volume for IPOs priced above the range and is highest for IPOs priced above the filing range.

2. From the analysis above, the paper finds:

a) Institutions flip more than retail customers;

b) The largest proportion of shares flipped by both institutions and retail customers is for IPOs priced above the filing range; and

c) The transaction size of shares flipped is larger for institutions than for retail customers, but lower than previously assumed.

3. The paper categorizes aftermarket price performance into four categories: very cold, cold, warm, and very hot.

a) In the sample, there are 36 very cold IPOs with raw returns on day 1 of zero percent or less. Fifty IPOs are considered cold because their day 1 return is greater than zero percent but less than or equal to 10%. Ninety three IPOs are classified as warm with day 1 returns between 10%

and 60%, and 14 IPOs are considered very hot with day 1 returns greater than 60%.

b) Turnover is much higher for very hot IPOs (averaging 188.63%) as compared to very cold IPOs (58.40%).

(1) And although flipping accounts for a large proportion of the volume in weak IPOs, this result can be attributed to the low volume for cold IPOs.

(2) Another explanation for lower flipping activity in very cold IPOs is the use of explicit and implicit mechanisms, such as penalty bids, when offering price support.

4. The main results from this set of are:

a) Institutions flip a much larger portion of the shares allocated to them than do individuals;

b) Institutions and retail customers both flip a greater percentage of their allocation when the IPO is hot rather than cold;

c) Only a small percentage of trading volume is due to flipping by either institutions or retail customers; and

d) Institutional flipping is not necessarily done in large blocks.

5. This paper attempts to group investment banks with large retail operations under “retail banks,” and all others grouped into a second category called “non-retail banks.”

a) According to the paper, retail banks allocate a significantly power proportion of an IPO to institutions (63.07%) as compared to non-retail banks (75.94%).

6. Also, only 5.75% of shares offered in an IPO are flipped in the first two days of trading for retail banks. In stark contrast, 16.69% of shares are flipped for non-retail banks.

a) This strongly suggests that customers of retail banks flip less than the customers of non-retail banks.

7. There are 122 IPOs on Nasdaq and 71 on the New York Stock Exchange or the American Stock Exchange (“NYSE/AMEX”).

a) Nasdaq IPOs are smaller as measured by issue size and offer price, and have higher initial returns at 23.98% compared with 10.89% for NYSE/AMEX IPOs. Notwithstanding, flipping is actually higher on Nasdaq.

8. The data from the paper's sample demonstrates that institutions flip a larger percentage of shares allocated to them in IPOs with higher initial returns.

a) This result is important because it reiterates an earlier finding that more flipping is done by institutions for hot IPOs.

9. This paper also documented that flipping, on average, accounts only for a small proportion of the high trading volume observed in the IPO aftermarket and removes the misconception that the high trading volume is primarily due to flippers.

10. This paper concludes by reiterating its main findings.

a) Initial trading volume is high in IPOs; however, flipping accounts for a small proportion of this trading volume.

b) Flipping does not make up a large proportion of the volume in cold IPOs relative to hot IPOs; even so, the result may be due to the low total trading volume of cold IPOs rather than to more flipping.

c) Institutions consistently flip a larger proportion of shares allocated to them than do retail customers.

d) Transaction size is higher for cold IPOs because each institution is allotted a smaller amount of shares in hot IPOs.

H. Jay R. Ritter, *Differences Between European and American IPO Markets* (December 2003)[580]

1. This survey covers recent developments in the European initial public offering ("IPO") market by discussing the rise and fall of the European NM markets that was fueled by the busiest IPO market in European history.

2. The survey then discusses the various mechanisms for pricing and allocating IPOs and compares the differences between European and U.S. practices.

3. The Rise and Fall of the Euro NM Markets

a) The rise of the European NM markets can be attributed to the need for a market that caters to young growth companies. Specifically, in 1997, Germany's Neuer Markt was founded for this purpose.

(1) Other NM markets were established in Italy (the Nuovo Mercato), the Netherlands (Nieuwe Markt), Belgium (Euro.NM Belgium), and France (the Nouveau Marche).

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[580] Jay R. Ritter, *Differences Between European and American IPO Markets*, 9 EUR. FIN. MGMT. 421 (Dec. 2003).

b) The fall of the Euro NM markets at the end of 2000 resulted because investor interest remained local for these small companies.

(1) As a consequence, although the Nemax 50 index of Neuer Markt stocks rose from its December 31, 1997, starting value of 1000 to a peak of 9631 on March 10, 2000, it collapsed to only 313 on October 7, 2002.

(2) Later in 2002, the Neuer Markt announced that it was shutting down.

c) Until fairly recently, most European stock exchanges have had listing requirements that focused on financial requirements, such as having three years of positive earnings before going public. In contrast, the listing standards for the Euro NM markets have focused on disclosure and corporate governance.[581]

4. Mechanisms for Pricing and Allocating IPOs

a) There is a decline in the fixed-price and auction mechanisms for selling IPOs in Europe. Instead, Europe is experience a growth in the use of the bookbuilding mechanism.[582]

(1) The study defines "fixed price mechanisms" as contracts where the offer price is set relatively early, before much information about the demand is known, which tends to result in a high level of underpricing.

(2) In contrast to the U.S. style of bookbuilding, where the price range is typically set at the beginning of the process, German IPOs set the price range after bookbuilding has started.

b) In 1999-2000, the survey states that there were huge amounts of money left on the table with many IPOs being heavily oversubscribed. With bookbuilding, underwriters have discretion in allocating shares. There are three views about how IPOs are allocated:

(1) The Pitchbook view, which states that underwriters will use their discretion to allocate shares to

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[581] Giancarlo Giudici & Peter Roosenboom, *Pricing Initial Public Offerings on "New" European Stock Markets*, (EFMA Conference Working Paper 2002) *available at* http//ssrn.com/abstract=314275.

[582] Bruno Biais & Anne Marie Faugeron-Crouzet, *IPO Auctions: English, Dutch, …French and Internet*, 11 J. OF FIN. INTERMEDIATION 9 (Jan. 2002); Alexander Ljungqvist et al., *Global Integration in Primary Equity Markets: The Rold of U.S. Banks & U.S. Investors*, 16 SOC'Y FOR FIN. STUD. 63 (2003).

institutional investors who are likely to be long on the stock;

(2) The Academic view, which states that "regular" investors will be allocated shares in return for truthfully revealing their estimate of share value; and

(3) The Profit-sharing view, which states that underwriters allocate hot IPOs to investors in return for commission business.

5. Differences Between European and U.S. Practice

a) One primary difference is the importance of analysts in the IPO process and the role of analyst conflicts of interest.

(1) The reason favorable analyst coverage is important once the issuing company is public is because investment bankers have found that they can effectively compete for deals by either implicitly or explicitly committing to have a highly regarded analyst cover a stock and issue positive recommendations.[583]

b) Also, U.S. issuing firms are subject to a "quiet period," whereby from the decision to go public until 40 calendar days after going public, analysts that are affiliated with underwriters are prohibited from issuing research reports or recommendations.

(1) In Europe, quiet period restrictions do not exist, allowing both affiliated and unaffiliated analysts to issue research reports while an IPO is sold as well as immediately after going public.

c) Another important difference between European and U.S. practice is that class action lawsuits are common in the U.S. but rare in Europe.

(1) In the U.S., several law firms specialize in suing corporations and their officers and directors. Van der Goot (2003)[584] argues that legal risk is one of the reasons that higher quality underwriters are less likely to take riskier companies public in the Netherlands.

[583] In other studies, such as Craig Dunbar, *Factors Affecting Investment Bank Initial Public Offering Market Share*, 55 J. OF FIN. ECON. 3 (2000) and Laurie Krigman et al, *Why Do Firms Switch Underwriters?*, 60 J. OF FIN. ECON. 245 (2001), there is an indication that the desire for favorable analyst coverage is so strong that underwriters with top-ranked analysts are able to charge high gross spreads and leave more money on the table while still having high market shares for IPO underwriting.

[584] Tjalling van der Goot, *Risk, the Quality of Intermdiaries and Legal Liability in the Netherlands IPO Market*, 23 INT'L REV. OF LAW & ECON. 121 (2003).

d) Yet, Keloharju (1993)[585] and others have argued that the threat of lawsuits cannot be an important motivation for underpricing in countries like Finland because class action lawsuits there are rare. Even so, class action lawsuits do arise if abuses are too extreme. An example of this is with the March 2000 World On-line IPO on the Amsterdam Stock Exchange.[586]

6. Valuation, Control, and Long-Term Returns

a) Valuation can affect a firm's decision to go public.

b) There are two general approaches to valuation:

(1) Examine the valuation of individual companies or groups of companies, either using discounted cash flow analysis or comparable firm multiples; and

(2) Examine not the level of valuation, but the long-run returns, which can be though of as changes in valuations over time.

c) Roosenboom and Van der Goot (2003)[587] use valuation analysis to examine the effect of takeover defenses on firm value at the time of going public, and Knauf, Roosenboom, and Van der Goot (2003)[588] examine whether accounting information helps explain the valuation of internet IPOs at the peak of the boom in internet IPOs.

d) The second approach to valuation, according to the paper, addresses the question of whether firms were valued appropriately, although large samples over long time periods are generally required to find statistically significant abnormal performance.

(1) Particularly, there are relatively small sample sizes that exist for most European studies in comparison to the thousands of IPOs over many decades in the U.S.

7. Conclusions

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[585] Matti Keloharju, *The Winners Curse, Legal Liability, and the Long Run Price Performance of Initial Public Offerings in Finland*, 34 J. OF FIN. ECON. 251 (1993).

[586] In the World On-line IPO, the company chairwoman, Nina Brink, had sold a substantial number of her shares immediately prior to the offering in a sale at a price of 6 Euros, much less than the offer price of 43 Euros, but with an additional payment contingent on the market price of the shares once trading commenced. Her transaction was economically equivalent to selling some of her shares in the open market immediately after trading commenced, and was apparently designed to avoid any lockup restrictions.

[587] Peter Roosenboom & Tjalling van der Goot, *Takeover Defenses and IPO firm Value in the Netherlands*, 9 J. OF EUR. FIN. MGMT. ASS'N 485 (SPECIAL ISSUE) (2003).

[588] Pieter Knauff et al., *Is Accounting Information Relevant to Valuing European Internet IPOs?*, NEW VENTURE FINANCING (2003).

a) This brief survey does not predict how future practice and research on European IPOs will develop.

b) In addition, this survey has not been able to cover all of the current research being done with a European IPO focus but instead has discussed the evidence on the long-run performance of European IPOs.

c) Today, questions that are being addressed include how IPOs are allocated, and what causes the severe fluctuations in volume in IPO markets. The survey states that even if these questions are answered, new questions will develop due to the evolving financial markets.

XXXV. REGUALTORY ISSUES CONCERNING IPO ALLOCATION

A. NASD/FINRA IPO Allocation Rule Proposal

1. FINRA is proposing to create new Rule 2712[589] and amend existing Rule 2710 to prohibit certain IPO allocation abuses. The federal securities laws and existing FINRA rules already prohibit certain IPO allocation abuses. These laws and rules would continue to apply if FINRA adopts proposed new Rule 2712. Nevertheless, new, specifically targeted provisions in Rule 2712 would aid member compliance efforts and help to maintain investor confidence in the capital markets. In particular, the proposal would expressly prohibit certain abuses in the allocation and distribution of shares in IPO's.

B. Prohibit Quid Pro Quo Allocations – NASD Rule2712(a)

1. Members and their associated persons may not offer or threaten to withhold IPO shares it allocates as consideration or inducement for the receipt of excessive compensation in relation to the services provided by the Member.

C. Spinning – NASD Rule 2712(b)

1. Members and their associated persons may not allocate IPO shares to an executive officer or director of a company, or to a person "materially supported" by such executive officer or director, if:

a) The member has received compensation from the company for investment banking services in the past 12 months;

b) The member expects to receive or intends to seek investment banking business from the company in the next 6 months; or

[589] Notice of Proposed Rule Change for NYSE and NASD Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in IPOs, Exchange Act Release No. 50896 (Dec. 20, 2004).

(1) If a member allocates shares within the 6 months, it is presumptive spinning, which the member may then rebut.

c) On the express or implied condition that such person will direct future investment banking business to the Member.

D. Policies Concerning Flipping – NASD Rule2712(c).

1. Members and their associated persons may not directly or indirectly recoup, or attempt to recoup, any portion of a commission or credit paid or awarded to an associated person for selling shares in an IPO that are subsequently "flipped" by a customer, unless the managing underwriter assesses a "penalty bid" on the entire syndicate.

2. Member must keep records of "penalty bids" or disincentives.

E. Definitions – NASD Rule 2712(d)

1. "Flipped" means the initial sale of IPO shares purchased in an offering within 30 days following the offering date of such offering.

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

3. "Material support" means directly or indirectly providing more than 25% of a person's income in the prior calendar year. Persons living in the same household are deemed to be providing each other with material support.

F. IPO Pricing and Trading Practices NASD Rule 2712(e)

1. Equity IPOs

a) Reports of Indications of Interest and Final Allocations – NASD Rule 2712(e)(1)

(1) The book-running lead manager would have to provide to the issuer's pricing committee (or its board of directors):

(a) A regular report of indications of interest, including the names of interested institutional investors and the number of shares indicated by each, as reflected in the book-running lead manager's book of potential institutional orders, and a report of aggregate demand from retail investors; and

(b) After the settlement date of the IPO, a report of the final allocation of shares to institutional investors as reflected in the books and records of the book-running lead manager, including the names of purchasers and the number of shares purchased by each, and aggregate sales to retail investors.

b) Lock-Up Agreements – NASD Rule 2712(e)(2)

(1) Any lock-up agreement or other restriction on the transfer of the issuer's shares by officers and directors of the issuer in an equity IPO shall provide that:

(a) The lock-up restrictions will apply to their issuer-directed shares; and

(b) At least two business days before the release or waiver of any lock-up or other restriction on the transfer of the issuer's shares, the book-running lead manager will notify the issuer of the impending release/waiver and announce such through a major news service.

c) Agreement Among Underwriters – NASD Rule 2712(e)(3)

(1) The agreement among the underwriters must require that any shares returned by a purchaser to a syndicate member after secondary market trading commences must:

(a) Be used to offset any existing syndicate short position, and then, upon exhaustion of any such short position; or

(b) Be offered at the public offering price to unfilled customers' orders pursuant to a random allocation methodology.

d) Market Orders – NASD Rule 2712(e)(4)

(1) Members would be prohibited from accepting market orders for the purchase of equity IPO shares during the first day that such IPO shares commence trading on the secondary market.

XXXVI. Key IPO Allocation Abuse Cases

A. Credit Suisse First Boston Corp. ("CSFB") (January 22, 2002)[590]

1. CSFB settled with the SEC for alleged abusive practices by taking advantage of its position as underwriter by allocating shares of hot IPOs to customers who agreed to share their IPO profits by paying excessive commissions. CSFB agreed to pay a total of $100 million to resolve the SEC's charges and a related action by NASD. CSFB also agreed to be enjoined from future violations of NASD Rules 2110, which prohibits violation of just and equitable principles of trade, and 2330, which prohibits sharing in the profits of customer accounts, as well as Section 17(a)[591] of the Exchange Act and Rule 17a-3[592] thereunder. Additionally, CSFB agreed to institute wide-ranging new procedures to prevent a recurrence of such misconduct.

B. JP Morgan Securities, Inc. (October 1, 2003)[593]

1. J.P. Morgan settled a civil injunctive action with the SEC relating to the firm's allocation of stock to institutional customers in IPOs it underwrote during 1999 and 2000. In the settlement, J.P. Morgan consented to a final judgment that would permanently enjoin them from violating Rule 101[594] of Regulation M and NASD Rule 2110, and order it to pay a $25 million civil penalty. In its complaint the SEC alleged J.P. Morgan:

a) Violated Rule 101 of Regulation M by attempting to induce certain customers who received allocations of IPOs to place purchase orders for additional shares in the aftermarket;

b) In fact induce certain customers to place such orders and such customers often purchased stock during the issues' first few trading days; and

c) In another instance, J.P. Morgan, violated NASD Rule 2110, by persuading one or more customers in July 1999, to accept an allocation of a "cold" IPO (i.e., one where there is little interest in IPO shares) by promising the reward of an allocation of an upcoming oversubscribed IPO.

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[590] SEC Sues CSFB for IPO Violations; CSFB Will Pay $100 Million, Litigation Release No. 17327 (Jan. 22, 2002).

[591] 15 U.S.C. § 78q(a).

[592] 17 C.F.R. § 240.17a-3.

[593] SEC Sues J.P. Morgan Securities Inc. for Unlawful IPO Allocation Practices; J.P. Morgan Agrees to Settlement Calling for Injunction and Payment of $25 Million Penalty, Litigation Release No. 18385 (Oct. 1, 2003).

[594] 17 C.F.R. § 242.101.

C. Goldman Sachs & Co. / SEC v. Morgan Stanley & Co. (January 25, 2005)[595]

1. Goldman Sachs and Morgan Stanley settled with the SEC in lawsuits alleging identical violations of Rule 101 of Regulation M during 1999 and 2000. Specifically, Goldman Sachs and Morgan Stanley allegedly induced certain customers who received allocations of IPOs underwritten by the firms to place additional purchase orders for shares in the aftermarket. The terms of the settlement for both were identical, with each firm paying a fine of $40 million dollars as well as being permanently enjoined from violating the rule again.

XXXVII. Commission Guidance Regarding Prohibited Conduct in Connection with IPO Allocations[596]

A. The SEC published this interpretive release with respect to prohibited conduct in connection with securities distributions, particularly with a focus on initial public offering ("IPO") allocations.

B. The purpose of the release was to provide guidance under Regulation M with respect to the process of book-building, including the process for allocating shares in IPOs. The Commission had brought three enforcement cases alleging abuses in the offering process in contravention of Regulation M. Based on these cases, the commission sought to highlight certain prohibited activities that underwriters should avoid during restricted periods. These include those outlined below.

1. Inducements to purchase in the form of tie-in agreements[597] or other solicitations of aftermarket bids or purchases prior to the completion of the distribution.

2. Communicating to customers that expressing an interest in buying shares in the immediate aftermarket ("aftermarket interest") or immediate aftermarket buying would help them obtain allocations of hot IPOs.

a) The focus of this communication is clearly to attempt to induce customers to bid for or purchase securities in the immediate aftermarket in return for an allocation.

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[595] Press Release 2005-10, SEC, SEC Sues Morgan Stanley and Goldman Sachs for Unlawful IPO Allocation Practices; Each Firm Agrees to Settlement Calling for Injunction and Payment of $40 Million Penalty, (Jan. 25, 2005), *available at* http://www.sec.gov/news/press/2005-10.htm.

[596] Commission Guidance Regarding Prohibited Conduct in Connection with IPO Allocations, Securities Act Release No. 8565, Exchange Act Release No. 51500, Investment Company Act Release No. 26828 (Apr. 7, 2005).

[597] Tie-in agreements are agreements or contracts for the purchase of shares in the after market in exchange for an allocation. Such contracts may also violate the antifraud provisions of the Securities Act and the Exchange Act, and Section 5 of the Securities Act (15 U.S.C. § 77e). The solicitation of a tie-in is prohibited, irrespective of whether an agreement or contract to purchase results.

b) However, inquiring as to customers' desired future position in the longer term (for example, three to six months) and the price or prices at which customers might accumulate that position, without reference to immediate aftermarket activity, does not, without more, fall within this violative conduct.

3. Soliciting customers prior to the completion of the distribution regarding whether and at what price and in what quantity they intend to place immediate aftermarket orders for IPO stock.[598]

a) Where the sales representative inquires whether the customer intends to place orders in the immediate aftermarket, and if so, at what prices and quantities, the clear expectation and understanding is that the customer will submit aftermarket orders at the prices and quantities discussed if the customer receives an allocation of shares.

b) However, inquiring as to a customer's desired future position in the longer term (for example three to six months), and the price or prices at which the customer might accumulate that position without reference to immediate aftermarket activity, does not, without more, fall within this violative conduct.

c) Soliciting aftermarket interest from customers that the distribution participant knows, or should know, have no interest in long-term holdings of the stock of IPO companies, may show that the firm or salesperson was attempting to induce aftermarket activity.

4. Proposing aftermarket prices to customers or encouraging customers who provide aftermarket interest to increase the prices that they are willing to place orders in the immediate aftermarket.

a) Proposing aftermarket prices to customers creates the impression of a strong offering demand and a scarcity of offering shares, which can facilitate a distribution.

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[598] The District Court in In re *Initial Public Offering Antitrust Litigation* (287 F. Supp. 2d 497 (S.D.N.Y. 2003), *vacated sub nom.* Billing v. Credit Suisse First Boston, 426 F.3d 130 (2d.Cir. 2005), *vacated* 127 S.Ct. 1867 (2007)) stated that "inquiries of customers or others interested in purchasing Class Securities concerning the number of shares that such person would be willing to purchase in the aftermarket and the prices such person would be willing to pay for the shares" are actions that are "expressly permitted during the 'road show' period." Id. at 508. However, no provision of the federal securities laws expressly permits the conduct described in the quotations during the "roadshow" period. In fact, depending on the facts and circumstances, if the "roadshow" period overlaps with a restricted period defined in Regulation M (17 C.F.R. §§ 242.100 – 105), then such actions may represent attempt to induce aftermarket bids or purchases in violation of Rule 101 of Regulation M (17 C.F.R. § 242.101).

b) Encouraging customers who provide aftermarket interest to increase the price level at which they are willing to place orders in the aftermarket conveys to customers that bidding for or purchasing in the immediate aftermarket at price levels higher than their own initial price level or higher than other customers' aftermarket price levels is expected in consideration for an allocation or an improved allocation in the IPO.

c) Communication to customers of information obtained from third parties regarding their valuation of an issuer or the offering price is not violative where the conduct would not be likely to cause the customer to express an interest in paying a higher price in the immediate aftermarket.

d) Encouraging an increase in prices, including by communication of prices of aftermarket interest of third parties would be viewed as improperly conveying to a customer that a commitment in the aftermarket at higher price levels is expected as described above.

5. Accepting or seeking expressions of interest from customers that they intend to purchase an amount of shares in the aftermarket equal to the size of their IPO allocation ("1 for 1") or intend to bid for or purchase specific amounts of shares in the aftermarket that are pegged to the allocation amount without any reference to a fixed total position size.

a) By seeking this type of aftermarket interest from customers, the underwriter would be attempting to induce customers to place orders or buy in the aftermarket. In contrast, it is possible that a customer could express a desire to purchase in the aftermarket without prompting from the salesman.

b) Where the customer's statement is spontaneous, there may be no "attempt to induce" by the salesperson.

c) However, if, for example, there had been a prior course of dealing between the firm and the investor through which the firm communicated that the investor was expected to provide this type of aftermarket price and quantity information, the seemingly spontaneous statement of an intention to make aftermarket purchases may in fact have been induced by the firm.

d) In any event, whether or not the customer's statement is spontaneous, if a sales representative accepts a customer's offer to purchase shares in the immediate aftermarket that is

expressly linked to the receipt of an allocation, this is a prohibited tie-in agreement and violates Regulation M.[599]

6. Soliciting aftermarket orders from customers before all IPO shares are distributed or rewarding customers for aftermarket orders by allocating additional IPO shares to such customers.

a) If all of the IPO shares have not been distributed, an underwriter is still in a restricted period and prohibited from attempting to induce aftermarket activity.[600]

b) By soliciting orders or rewarding customers who place orders in the immediate aftermarket with additional IPO shares in the same offering, the underwriter is improperly stimulating aftermarket purchases during the restricted period.

7. Communicating to customers in connection with one offering that expressing an interest in the aftermarket or buying in the aftermarket would help them obtain IPO allocations of other hot IPOs.

a) In this scenario, the broker would be inducing or attempting to induce aftermarket bids or purchases by linking an expectation of aftermarket bids or purchases to the customer's desire to receive allocations in future hot IPOs.

b) However, deterring that a customer is or may be a long-term investor in the securities of an issuer or one or more other issuers and communications with a customer in connection with that determination do not, in and of themselves, violate Regulation M, whether or not a customer engages in aftermarket bids or purchases.

c) Each of the above activities is an improper attempt to induce investors to bid for or purchase covered securities in

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599 By accepting such a commitment, the firm also may violate Section 5 under the Securities Act. In contrast, for example, where a sales representative rejects the offer to make aftermarket purchases linked to the receipt of an allocation, and informs the customer that firm policy prohibits allocation of that basis, the firm would not have engaged in activity that constitutes a prohibited tie-in agreement in violation of Regulation M, notwithstanding that the customer ultimately was allocated IPO shares.

600 The definition of restricted period in Rule 100 of Regulation (17 C.F.R. § 242.100) provides that a restricted period ends upon "such person's completion of participation in the distribution." In the Adoption Release the Commission stated, "[u]nder Regulation M, a person determines when its completion of participation in the distribution occurs based on the person's role in the distribution. An underwriter is deemed to have completed its participation in a distribution when its participation has been distributed…and after any stabilization arrangements and trading restrictions in connection with the distribution have been terminated. The definition contains a provision that an underwriter's participation is not deemed to be completed, however, if a syndicate overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of such exercise." Anti-Manipulation Rules Concerning Offerings, Securities Act Release No. 7375, Exchange Act Release No. 38067, Investment Company Act Release No. 22412 (Dec. 20, 1996).

the aftermarket in order to receive IPO allocations.[601] These solicitations or attempts to induce aimed at aftermarket transactions tend to:

(1) Create offering demand;

(2) Cause artificial aftermarket price escalation; and

(3) Erode market integrity.

d) As stated before, when offerings are sold based upon an artificially manufactured perception of scarcity and priced on stimulated buying pressure, IPO investors are unable to evaluate the offering to determine that it has been appropriately priced. Moreover, other investors who bid for or purchase shares in the aftermarket would not know that the aftermarket demand had been stimulated by the underwriters' unlawful conduct.

e) In addition, certain conduct occurring after the restricted period, while not of itself illegal, could be evidence that a distribution participant attempted during the restricted period to induce customers to bid for or purchase stock in the aftermarket.[602]

f) Recent enforcement cases contain examples of such activity including:

(1) Follow-up solicitations for immediate aftermarket orders from customers who had provided aftermarket interest earlier; and

(2) Tracking or monitoring customers' aftermarket purchases to see whether they had followed through on their aftermarket interest.[603] It is recognized that there are legitimate reasons to monitor customer activity.

g) However, tracking customers' aftermarket purchases in the first few days of trading following an IPO could be

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

[602] While aftermarket transactions can serve as evidence that there had been an attempt to induce aftermarket bids or purchases, such evidence is not required to establish an attempt to induce in violation of Regulation M. Additionally, oral attempts to induce aftermarket activity can be evidenced in a variety. *See e.g.*, Americorp, Inc., Exchange Act Release No. 41728 (Aug. 11, 1999) (broker-dealer representatives prepared order tickets for aftermarket orders prior to the IPO becoming effective).

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

evidence supporting a claim that the customers' expressions of desire to purchase in the aftermarket were induced.

XXXVIII. POLICIES AND PROCEDURES

A. Underwriters should have effective policies and procedures to detect and prevent prohibited solicitations, tie-in agreements, and other attempts to induce aftermarket bids or purchases during the Regulation M restricted period.[604] Firms should implement policies that, at a minimum, prohibit and monitor for the activities discussed in this release. Procedures and systems for applying policies should be in place so that sales representatives and other firm employees are reasonably supervised with a view to preventing and detecting improper attempts to induce aftermarket bids or purchases during a restricted period. Firms also should take corrective action if breaches occur.

1. Dot Com IPO Cases Dismissed. The Supreme Court finds that securities law preempts antitrust law.[605]

2. In *Credit Suisse Securities (USA) LLC v. Billing*, the Supreme Court held that securities law and antitrust law are clearly not incompatible, and that federal securities law impliedly precludes the application of antitrust laws to the regulation of underwriting syndicates.

3. This reversed the decision of the Second Circuit Court of Appeals,[606] which had not dismissed the antitrust causes of action pertaining to a series of initial public offerings.

4. The plaintiffs, a class of person who had purchased securities in the post-IPO market from March 1997, through December 2000, alleged that the defendant underwriters participated in several anti-competitive activities, including "laddering," "tying," and charging unusually high commissions.

5. The practice of "laddering" consists of requiring buyers to purchase additional shares of a security on a later date at

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[604] *See e.g.*, Exchange Act Section 15(b)(4)(E) (15 U.S.C. § 78o(b)(4)(E)). *See also* NASD Rule 3010(a) (requiring member firms to establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable FINRA rules, federal securities laws and rules); NASD, Request for Comment on Regulatory Approaches to Enhance IPO Pricing Transparency, NTM 03-72 (Nov. 2003) *available at* http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003067.pdf; IPO Advisory Committee Report, at 6, 10 (encouraging underwriters to develop effective internal policies and procedures to prevent prohibited secondary market activity and recommending that underwriters impose additional requirements to promote the highest standards of conduct, including: (1) enhanced periodic internal review by the underwriter of its IPO supervisory procedures; and (2) a heightened focus on the IPO process in SRO examinations for investment banking personnel).

[605] Credit Suisse Securities (USA) LLC v. Billing, 127, S.Ct. 2383 (2007).

[606] Billing v. Credit Suisse First Boston Ltd., 426 F.3d 130 (2d. Cir. 2005).

escalating prices, while "tying" includes requiring purchasers of IPO securities to also purchase other less desirable securities.

6. Allegedly, the aggregate effect of taking these actions was to ensure that the price of a security would continue to increase in the time period following an IPO.

B. The Supreme Court used a four-pronged analysis to determine that the federal securities laws impliedly preempted antitrust law.

1. First, the Court determined that the alleged practices of jointly promoting and selling newly issued securities were central to the proper functioning of well-regulated capital markets, and that these practices lie at the heart of the enterprise that the SEC regulates.

2. Second, the law grants the SEC the authority to supervise all of the questionable activities, and gives individuals a private right of action under those laws that would allow individuals to recover damages.

3. Third, because antitrust law prohibits certain activities that the securities regulations permit or even encourage, the conflict between antitrust law and securities law rose to a level of incompatibility.

4. Fourth, the SEC has continuously exercised its power to regulate the conduct in question and, thus, there would be no gap in the law if antitrust causes of action were precluded.

C. The test itself, together with the arguments used to justify the results, reflects a concern that the SEC, as an agency designed to regulate the securities markets, is better equipped to make decisions about what practices should be permitted and what practices should be abolished, and on which side of that line the practices fall. The Court determined that, due to the factors involved in this case, mistakes would be unusually likely if antitrust authorities were allowed to regulate this area, rather than the SEC.

1. This echoed the sentiment of the SEC, which, in an amicus brief, expressed concern that allowing the antitrust claims to move forward could have a chilling effect on underwritten offerings, since "the fear of potentially crippling treble damages awards could cover-deter conduct that would serve the interest of the markets and the capital formation process."[607]

2. In addition, the Court noted that the laddering and tying practices that provided the basis of the antitrust complaint are illegal under the federal securities laws. Thus, even where the

[607] Brief for SEC as Amicus Curiae Supporting Appellee, Billing v. Credit Suisse First Boston Ltd., 426 F.3d 130 (2d. Cir. 2005) (No. 03-9284L, 03-9288CON).

results of an antitrust lawsuit and a securities lawsuit would be the same, the antitrust cause of action is still precluded.

3. As a result of this decision, it is clearer that the SEC, FINRA, and other self-regulatory organizations govern the actions of underwriters in an initial public offering or other underwritten offering.

4. This case may provide certain important limitations on the types of class-action lawsuits that plaintiffs may bring against underwriters in the future. Since antitrust causes of action are being precluded with respect to securities offerings, a securities law case may not be brought before the court in the guise of an antitrust case.

5. This is important as a limitation on the potential liability of an underwriter, since a successful antitrust plaintiff would be entitled to recover treble damages and the 1995 securities litigation reforms do not apply to antitrust causes of action.

6. The decision also represents a bit of a turf battle between the SEC and the Antitrust Division of the Department of Justice, which had argued in support of the plaintiff's position that the antitrust claims were not precluded by the federal securities laws.[608]

7. The decision demonstrates that the Supreme Court may hold conduct exempt from the antitrust laws, despite the Department of Justice's urging to the contrary.

[608] Brief for the United States as Amicus Curiae Supporting Vacatur, Credit Suisse First Boston Ltd. v. Billing, 127 S.Ct. 2383 (2007) (No. 05-1157).