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Client Alert Commentary

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What's the Deal with Regulation M?

A Desktop Reference and FAQs to Help Navigate Regulation M

Regulation M addresses certain activities that could be viewed as artificially impacting the price of an offered security. It is intended to protect the integrity of the securities offering process by preventing persons with a financial interest in a securities offering from taking particular actions that might manipulate the market for the securities being offered.[1] This *Client Alert* examines the ins and outs of Regulation M, which was adopted in 1996 by the US Securities and Exchange Commission under the Securities Exchange Act of 1934 (the Exchange Act), and provides answers to some of the most frequently asked questions regarding Regulation M.

General Framework

Regulation M consists of six rules:

- **Rule 100** sets forth the definitions of certain terms used in Regulation M.
- Rules 101 and 102 regulate bids for and purchases of the offered securities and certain other covered securities. More specifically:
  - **Rule 101** regulates bids and purchases by **distribution participants** (including underwriters and selling group members) and their **affiliated purchasers**; and
  - **Rule 102** regulates bids and purchases by **issuers**, **selling securityholders** and their **affiliated purchasers**.
- **Rule 103** governs the extent to which distribution participants that are also NASDAQ market makers can continue to engage in certain **passive market making** activities.
- **Rule 104** addresses permissible **stabilization** arrangements that may be used to facilitate an offering.
- **Rule 105** restricts **short selling** activities that may take place in connection with certain types of offerings.

Key Terms

Distribution – an offering of securities, whether or not registered under the Securities Act of 1933 (the Securities Act), that is distinguished from ordinary trading transactions by the magnitude of the offering (*i.e.,* the amount of securities to be sold and the percentage of outstanding securities, public float and trading volume those securities represent) and the presence of special selling efforts and methods (*e.g.,* payment of greater than normal sales commissions and/or the use of a roadshow, prospectus or sales

memorandum). Note that in the case of shelf offerings, each takedown must be individually examined to determine whether it constitutes a "distribution." In addition, a private placement of securities can be a "distribution" for purposes of Regulation M if the offering satisfies the "magnitude" and "special selling efforts and selling methods" criteria. The issuance of securities in a merger can also be a Regulation M "distribution."

Distribution Participant – any underwriter, prospective underwriter, broker, dealer or other person that has agreed to participate or is participating in the distribution. For purposes of Regulation M, a "prospective underwriter" is one who has submitted a bid to the issuer or selling securityholder and knows or is "reasonably certain" that such bid will be accepted or who has reached or is "reasonably certain" to reach an understanding with the issuer, selling securityholder or managing underwriter that it will become an underwriter. Absent unusual circumstances, investment banks that attend the organizational meeting for an offering will typically be considered "distribution participants" for the offering.

Covered Security – the security being distributed in the offering (the subject security), and any security (a reference security) into which the subject security may be converted, exchanged or exercised,[2] or which, under the terms of the subject security, may in whole or significant part determine the value of the subject security.[3] So, for example, in a distribution of notes that are convertible into shares of common stock, the convertible notes are the "subject security," the common stock into which the notes can be converted is the "reference security" and both the convertible notes and the common stock are "covered securities" for purposes of Regulation M.

Affiliated Purchaser – any person (including non-US persons) acting in concert with a distribution participant, issuer or selling securityholder in connection with the acquisition or distribution of a covered security, or an affiliate whose purchases of a covered security are controlled by or under common control with a distribution participant, issuer or selling securityholder. In addition, subject to certain limited exceptions for specialist activity, any affiliate that acts as a market maker or engages as a broker or dealer in solicited transactions or proprietary trading activities in covered securities will be an affiliated purchaser. Other affiliates (including investment advisers and investment companies) that regularly purchase securities for their own account or for others, or that recommend or exercise investment discretion with respect to the purchase or sale of securities, may be able to avoid affiliated purchaser status if they can satisfy certain conditions intended to demonstrate their separateness from the affiliated distribution participant, issuer or selling securityholder (including through the use of independently assessed information barriers and the absence of overlapping officers or employees that direct, effect or recommend securities transactions).

Restricted Period – the period during which the trading prohibitions established by Regulation M apply. The length of this period depends on the size of the issuer's public equity float (*i.e.*, the amount of the issuer's common equity securities held by non-affiliates), the worldwide reported average daily trading volume (or ADTV) of the security and the type of transaction.

ADTV – the worldwide average daily trading volume during a specified period prior to the filing of the registration statement or, if there is no registration statement or the distribution involves the sale of securities off of a shelf registration statement pursuant to Securities Act Rule 415, the pricing of the offering (such point in time, the Applicable Test Date). For the specified period, distribution participants may choose either the two full calendar months immediately preceding the Applicable Test Date or any 60 consecutive calendar days ending within the 10 calendar days preceding the Applicable Test Date.[4]

The 411 on Rule 101

General Prohibition

In the context of distributions of securities, Rule 101 restricts distribution participants and their affiliated purchasers from bidding for, purchasing, or attempting to induce others to bid for or purchase, covered securities during the applicable restricted period. Rule 101 will *not* apply, however, if the offering does not rise to the level of a "distribution."

Restricted Period

Ordinary Offerings

For ordinary offerings (*i.e.*, offerings other than those occurring in the context of a merger, acquisition or exchange offer), the restricted period begins (i) on the first business day prior to the pricing of the offering if the security has ADTV of at least US$100,000 and the issuer of the security has a public float of at least US$25 million or (ii) on the fifth business day prior to the pricing of the offering for all other securities.[5]

The restricted period ends when the distribution participant has completed its participation in the distribution. For an underwriter, this occurs when the securities underwritten by it have been distributed (including through placement, under appropriate circumstances, into an investment account of the underwriter) and all stabilization arrangements and syndicate trading restrictions in connection with the distribution have been terminated. For an issuer or selling security holder, Regulation M takes a somewhat circular approach by providing that their restricted period ends when "the distribution is completed." This is generally understood in the case of underwritten distributions to mean the same time as the restricted period ends for the underwriters as described above.

Although the mere existence of an unexercised syndicate overallotment option will not in and of itself prolong the restricted period, it is important to note that if the overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of exercise the distribution will not be deemed complete as of the pricing date. In such case, any bids or purchases of covered securities made prior to the exercise of the option could, absent another exemption, constitute a violation of Regulation M.

Mergers, Acquisitions and Exchange Offers

In the context of mergers, acquisitions and exchange offers, the restricted period begins on the day proxy solicitation or offering materials are distributed to securityholders and ends at the time of the securityholder vote or the expiration of the offer. In addition, a separate restricted period will also apply with respect to any period during which the market price of the subject security will be used to determine the consideration to be paid to securityholders in connection with the merger, acquisition or exchange offer. Such additional restricted period will begin one or five business days prior to the commencement of the valuation period and will end at the termination of the valuation period.[6]

At-the-Market Offerings

The restricted period for a person participating in an at-the-market offering (which is defined as any offering other than a fixed price offering) begins one or five business days before the pricing of each sale and ends when the person's participation in the distribution has ended.

Important Exceptions

Excepted Securities

- Securities with ADTV of at least US$1.0 million whose issuer has common equity securities with a public float of at least US$150 million (such securities are commonly referred to as "actively-traded securities").
- Nonconvertible debt, nonconvertible preferred and asset-backed securities that are, in each case, rated by at least one nationally recognized statistical rating organization as "investment grade."[7]
- Securities that are "exempted securities" as defined in Section 3(a)(12) of the Exchange Act or that are face-amount certificates or securities issued by an open-end management investment company or unit investment trust.

Excepted Transactions

- Distributions of securities eligible for resale under Rule 144A of the Securities Act solely to persons that are or are reasonably believed to be "qualified institutional buyers" or "QIBs" (as defined in Rule 144A), in transactions exempt from registration under Securities Act Section 4(a)(2), Rule 144A or Regulation D,[8] and to persons not deemed to be "US persons" for purposes of Regulation S under the Securities Act (Rule 144A/Reg S transactions).[9]
- Transactions in connection with the distribution or complying with Rule 103 (passive market making) or Rule 104 (stabilization).
- Unsolicited brokerage transactions and unsolicited principal purchases that are not effected through a broker or dealer, on a securities exchange, or through an inter-dealer quotation system or electronic communications network. (Note that unlike predecessor Rule 10b-6 there is no requirement that unsolicited principal purchases be of "block" size.)
- Certain basket transactions and odd-lot and odd-lot related transactions.
- Exercises of any option, warrant, right or conversion privilege set forth in the instrument governing the security.
- Inadvertent violations that in the aggregate total less than 2% of a security's ADTV, if written procedures to achieve compliance with Rule 101 are maintained and enforced (the *de minimis* exception). Note that this exception can only be relied on up to the time the violations are discovered (*i.e.,* once the inadvertent violations are discovered, subsequent transactions would not be covered by this exception).

Issuer and Selling Securityholder Prohibitions Under Rule 102

General Prohibition

Rule 102 prohibits issuers and selling securityholders, and their respective affiliated purchasers, from bidding for, purchasing, or attempting to induce others to bid for or purchase, any covered security during the applicable restricted period.

Although Rule 102 repeats many of the same provisions set forth in Rule 101 and uses many of the same definitions, **certain of the exemptions included in Rule 101 are omitted from Rule 102**, primarily based on the SEC's view that issuers and selling securityholders have more of a direct stake in the proceeds of the offering and therefore may have a greater incentive to manipulate the price of covered securities.

Restricted Period

The commencement and duration of the restricted period applicable to issuers, selling securityholders and their affiliated purchasers is the same for purposes of Rule 102 as it is for purposes of Rule 101.

Unlike Rule 101, however, Rule 102 does *not* contain an exception for "actively-traded securities" issued by the issuer that is the subject of the distribution or an affiliate of such issuer.[10]

Important Exceptions

Excepted Securities

- Like Rule 101, Rule 102 excepts investment grade non-convertible debt, non-convertible preferred and asset-backed securities, as well as securities that are "exempted securities" as defined in Section 3(a)(12) of the Exchange Act or that are face-amount certificates or securities issued by an open-end management investment company or unit investment trust.[11]

Excepted Transactions

- Like Rule 101, Rule 102 contains exceptions for (i) certain odd-lot and odd-lot related transactions, (ii) the exercise in accordance with their terms of options, warrants, rights and convertible securities, (iii) unsolicited purchases, (iv) transactions in connection with the distribution and (v) Rule 144A/Reg S transactions.
- Rule 102 also contains exceptions for certain (i) repurchase transactions by closed-end investment companies, (ii) redemptions by commodity pools and limited partnerships and (iii) transactions in connection with qualifying issuer stock option, dividend reinvestment and other "plans."
- Unlike Rule 101, however, Rule 102 contains no "*de minimis* exception," nor an exception for basket transactions.

NASDAQ Passive Market Making Activities Under Rule 103

Rule 103 provides an exemption for the continuance of certain passive market making activities in a NASDAQ security by a distribution participant during the Rule 101 restricted period if the distribution participant is a registered market maker on NASDAQ. However, this exemption does not apply (i) if a stabilizing bid is in effect, (ii) during an at-the-market offering or (iii) during a best efforts offering.

The exemption sets forth explicit criteria that must be followed including with respect to pricing limitations, purchasing capacity, displayed size, designation of bids, regulatory notification and prospectus disclosure. NASDAQ market makers seeking to rely on this exemption will have well-developed policies and procedures designed to comply with the intricacies of Rule 103.

Stabilization Activities Under Rule 104

Coverage

Rule 104 provides that it is "unlawful for any person, directly or indirectly, to stabilize,[12] to effect any syndicate covering transaction,[13] or to impose a penalty bid,[14] in connection with an offering of any security" except in accordance with the provisions of Rule 104. Rule 104 further states that "[n]o stabilizing shall be effected at a price that the person stabilizing knows or has reason to know is in contravention of [the provisions of Rule 104] or is the result of activity that is fraudulent, manipulative, or deceptive under the securities laws, or any rule or regulation thereunder."

Rule 104 sets forth detailed and rather complex criteria (including with respect to stabilizing levels and initiating, maintaining, increasing or reducing stabilizing bids) in accordance with which stabilization and certain other activities used by distribution participants to facilitate an offering may proceed even if such activity takes place during a Rule 101 or 102 restricted period. It is important to note that Rule 104 applies to all "offerings"—not only to those that constitute "distributions" under Regulation M.

General Limitations

- Stabilizing is prohibited except for the purpose of preventing or retarding a decline in the market price of a security.
- Priority must be given to independent bids at the same price.
- No more than one stabilizing bid at the same price may be maintained in any one market.
- Stabilization is not permitted in connection with at-the-market offerings.

Significant Exceptions (and Missing Exceptions)

- Rule 144A/Reg S transactions.
- Distributions of "exempted securities," as such term is defined in Section 3(a)(12) of the Exchange Act.
- Non-US Stabilization – stabilizing may be conducted outside the United States during an offering in the United States without compliance with the requirements of Rule 104 if: (i) no stabilization is conducted in the US, (ii) the stabilization price is not above the US offering price and (iii) stabilization is conducted only in jurisdictions with stabilization regulations that the SEC has recognized as comparable to those in Rule 104 (so far, only the U.K. has been recognized by the SEC as having comparable regulations).[15]
- Unlike Rule 101, Rule 104 contains *no* exception for actively-traded securities.
- Unlike Rules 101 and 102, Rule 104 contains *no* exception for nonconvertible debt, nonconvertible preferred or asset-backed securities.

Disclosure and Recordkeeping Requirements

- Any person subject to Rule 104 that conducts a transaction in securities where the price may be or has been stabilized is required to notify the purchaser of such fact. Such notification is commonly made in the prospectus relating to the offering and in the confirmation statement sent to the purchaser upon completion of the transaction.
- Any person displaying or transmitting a bid that such person knows is for the purpose of stabilizing must provide prior notice to the market on which such stabilizing is being effected and must disclose the purpose of the bid to the person with whom it is entered.
- Rule 104 also imposes certain disclosure requirements with respect to post-offering (or aftermarket) syndicate activities. In particular, pursuant to Rule 104, any person that effects a "syndicate covering transaction" or imposes a "penalty bid" must provide prior notice thereof to the self-regulatory organization with direct authority over the principal market in the United States for the subject security.[16]

Short Sale Restrictions Under Rule 105

General Rule

In general, Rule 105 prohibits any person that has sold short a security that is the subject of a registered offering from purchasing securities in the offering from an underwriter, broker or dealer participating in the offering if the short sale took place during a specified period prior to the pricing of the offered securities (the pre-pricing period).[17] For purposes of the Rule, the pre-pricing period begins on the later of (i) the fifth business day before pricing or (ii) the initial filing of the registration statement, and ends with the pricing of the securities.

Scope

Rule 105 applies to registered offerings of equity securities for cash that are conducted on a firm commitment basis. Accordingly, Rule 105 is not applicable to (i) offerings of nonconvertible debt securities, (ii) offerings that are not registered under the Securities Act or (iii) best efforts offerings.

In addition, the Rule 105 Release clarifies that the Rule's reference to the security that is the "subject" of the offering is intended to be synonymous with the definition of "subject security" in Rule 100 of Regulation M. Thus, Rule 105 does not prohibit a person that shorted common stock in the pre-pricing period from purchasing securities that are convertible into or exchangeable for such common stock (*i.e.*, the prohibition does not extend to reference securities).[18]

Exceptions

Bona Fide Pre-Pricing Purchases

- Rule 105 permits a person that established a short position in the offered securities during the pre-pricing period to purchase securities in the offering if such person entered into a *bona fide* transaction that closed out that short position prior to the pricing of the offering.
- In order to qualify for the exception, the pre-pricing covering purchase must be (i) in an amount at least equal to the amount of the pre-pricing period short sale, (ii) effected during regular trading hours, (iii) reported pursuant to an effective transaction reporting plan and (iv) effected at least one business day prior to the pricing of the offering.[19]
- However, the exception is not available to a person that has effected a pre-pricing period short sale within the 30 minutes prior to the close of regular trading on the business day prior to the pricing date of the offering.

Purchases by Separate Accounts

- Rule 105 provides an exception for certain accounts that may be affiliated with each other or otherwise "related," but for which the decisions regarding securities transactions are made separately and without coordination or cooperation between the accounts (separate accounts).[20]
- This exception permits broker-dealers, investment advisers, individual investors and other persons to purchase securities in an offering even if a short sale was effected during the pre-pricing period on behalf of a related account, so long as the trading decisions for each account are "made separately and without coordination of trading or cooperation among or between the accounts."[21]

Purchases by Investment Companies

- Rule 105 also contains an exception specifically applicable to investment companies registered under Section 8 of the US Investment Company Act of 1940. This exception allows a registered investment company to purchase securities in the offering even if an affiliated investment company (or another fund in the same fund family or fund series) sold the offered security short during the pre-pricing period.

Frequently Asked Questions

Although it is not possible to tackle in this client alert every possible issue that can arise under Regulation M, we include our top 20 most frequently asked questions below.

1. Are all private placements exempt from trading restrictions under Regulation M?

No. Unless a private placement satisfies the criteria for Rule 144A/Reg S transactions, it will be subject to Regulation M trading restrictions unless another exception is available. It is possible that a particular private placement would not meet the magnitude and special selling efforts criteria necessary to constitute a "distribution" for purposes of Rules 101 and 102, but such determination would need to be made on a case-by-case basis after considering all the relevant facts.

2. Do the trading prohibitions of Rules 101 and 102 apply to transactions in derivatives?

Generally, no. "Rights to purchase" the security in distribution (which were restricted under predecessor Rule 10b-6) are not subject to trading restrictions under Rules 101 or 102. As a result, so long as the price of the derivative security is not used to determine the price of the security in distribution under the terms of the distributed security, options, warrants, rights and convertible securities are not subject to Rule 101 or Rule 102 restrictions during a distribution of the underlying security. Trading restrictions, however, will generally be applicable to the underlying security in connection with a distribution of the derivative security itself.

Because "rights to purchase" a subject security are not subject to the trading restrictions of Regulation M, a distribution participant (for purposes of Rule 101) or an issuer or selling securityholder (for purposes of Rule 102) may write (or sell) a put option or maintain a "short put" position with respect to the subject security during the restricted period for the subject security. Moreover, the Reg M Adopting Release clarifies that maintaining a short put position is *not* deemed to be a continuing bid for the underlying security for purposes of Regulation M.

Nonetheless, general manipulation concerns may still be raised if an issuer writes such a derivative security during a Regulation M restricted period with respect to the underlying security and knows or has reason to believe that the counterparty will effect purchases of the underlying security to hedge its position in connection with that derivative.

3. Do Regulation M trading restrictions apply to securities in the "same class and series" as the subject security?

No. Regulation M eliminated predecessor Rule 10b-6's restriction on securities of the "same class and series" as the security in distribution. Thus, for example, a distribution of an issuer's debt securities will not subject other debt securities of that issuer to trading restrictions under

Regulation M, unless such other debt securities are identical in all respects (including, among other terms, the coupon rate and maturity date) to the security in distribution. On the other hand, because of the elimination of the "same class and series" concept, most debt offerings (other than reopenings) will be subject to a five-day minimum restricted period because the offering will involve the issuance of a new security with no prior trading history.

Note, however, that an equity security that differs only in voting rights from the security in distribution is deemed to be the same security as the security in distribution and, therefore, will be a "covered security."

4. How is an issuer's public float calculated for purposes of determining a security's ADTV?

The Reg M Adopting Release provides that, for reporting issuers, the public float value should be taken from the issuer's most recent annual report on Form 10-K or be based upon more recent information made available by the issuer. For foreign private issuers (since the annual report on Form 20-F does not require disclosure of public float information), the Reg M Adopting Release states that the public float value should be determined in the same manner as provided in Form 10-K.[22]

5. For purposes of the exclusion from affiliated purchaser status for securities industry affiliates of distribution participants, issuers and selling securityholders, can an internal audit group of the distribution participant, issuer or selling securityholder perform the required annual independent review of such entity's information barrier policies and procedures?

Yes, under certain conditions. For an affiliated entity to qualify for the securities industry exclusion from "affiliated purchaser" status, the affiliated distribution participant, issuer or selling securityholder must (in addition to certain other requirements) maintain and enforce written policies and procedures reasonably designed to prevent the flow of information to or from the affiliate that might result in a violation of Rules 101, 102 and 104 of Regulation M and obtain an annual, independent assessment of the operation of such policies and procedures. The Reg M Adopting Release confirms that an internal audit group may be viewed as "independent" and perform this review if such group is independent of the corporate financing, trading and advisory departments of the distribution participant, issuer or selling security holder.[23]

6. Does Regulation M restrict the publication of research?

Yes. Rule 101 allows distribution participants and their affiliated purchasers to publish research reports (which, in general, have been thought to constitute inducements to purchase) during the applicable restricted period for a distribution *only* if such reports satisfy the requirements of Rule 138 or 139 under the Securities Act.[24]

Nonetheless, although Rule 138 and 139 qualifying research may be distributed throughout the applicable restricted period, some broker-dealers have elected, as a matter of internal risk-management policy (*i.e.,* to mitigate potential claims regarding the misuse of material nonpublic information or appearance of impropriety), to restrict, in connection with any distribution in which it is a distribution participant, (i) any publication of research regarding the issuer in distribution except in the ordinary course of its business and consistent with past practice and (ii) the inclusion in such research reports of increased estimates regarding the issuer's earnings and/or upgraded recommendations with respect to the issuer's securities, unless, in each case, such action is taken in

response to an event involving or affecting the issuer that has been previously disclosed to or is already known by the public.

Note that the SEC has not yet indicated how Regulation M restrictions on research during the restricted period apply to reports on emerging growth companies (or EGCs) that do not satisfy either the Rule 138 or 139 safe harbor, but that would satisfy the definition of research set forth in Section 2(a)(3) as modified by the Jumpstart Our Business Startups Act of 2012 (the JOBS Act). Under the JOBS Act, the SEC is prohibited from maintaining or adopting any rule that restricts a broker-dealer from publishing or distributing any research report or making any public appearance with respect to the securities of an EGC within any prescribed period of time following the effective date of the EGC's IPO. Although the JOBS Act prohibition does not address the period of time *before* the EGC's IPO—and thus appears not to be inconsistent with the pre-effective date portion of the Regulation M restricted period for an EGC IPO—it potentially raises an issue for "sticky offerings" (see below) and other offerings in which the "completion of the distribution" is not the same date as the pricing date for the offering.[25] It also raises an issue for a follow-on or secondary offering of securities that are not "actively-traded." In such case, Regulation M would prohibit distribution participants from publishing non-qualifying research during the applicable one- or five-day period prior to the pricing date for such offering.

7. How does the existence and exercise of an overallotment option affect the determination of when an underwritten distribution is deemed to be complete for purposes of ending the Regulation M restricted period?

An underwritten distribution is ordinarily deemed complete when all underwriters have distributed their allocations (*i.e.*, after all investors have confirmed their intent to purchase the securities allocated to them) and all syndicate restrictions have been lifted, even if the overallotment option (sometimes referred to as the "Green Shoe") granted to the underwriters in connection with the offering will be exercised in whole or in part at a later date (or not at all, due to covering purchases in the market). Successful distributions are typically completed on the pricing date and the possible exercise of the overallotment option at a later date should not normally prevent the distribution from being deemed completed as of the pricing or other "putative completion" date because the overalloted securities are sold and distributed at the same time as the firm commitment securities. However, if the overallotment option is exercised in an amount that exceeds the net syndicate short position (taking into account securities purchased in stabilizing or syndicate covering transactions), the distribution will not be deemed to have been complete as of the putative completion date and bids and purchases made prior to the exercise of the option could constitute a violation of Regulation M, unless an applicable exemption is available.

In certain offerings, underwriters may engage in a practice known as "refreshing the shoe." In such case, the syndicate short position may be reduced by purchases of the subject security made in the open market, and then reestablished in whole or in part by subsequent sales of the securities back into the market, after which time the syndicate short position is covered by the overallotment option. Because it is not clear whether such activity might extend the distribution period of the offering past the pricing date, underwriters will typically only "refresh the shoe" in connection with offerings in which they can take advantage of the actively-traded securities exception for their post-pricing activities. As a practical matter, this means that underwriters will not "refresh the shoe" in IPOs since the securities in distribution will not qualify for the actively-traded securities exception. In addition, because issuers

and selling securityholders do not have an actively-traded securities exception under Rule 102, it will be important for the underwriters to inform the issuer and/or selling securityholders (and their affiliated purchasers), that such activity is or may be taking place so that inadvertent Regulation M violations are avoided.

8. If an underwriter is an affiliate of the issuer or a selling securityholder, can the underwriter rely on the exceptions available under Rule 101 rather than the more limited exceptions available under Rule 102?

Yes, other than the actively-traded securities exception. Regulation M provides that an underwriter or other distribution participant that is also an affiliate of the issuer or selling securityholder will be subject to Rule 101 rather than Rule 102, but an affiliated distribution participant (even one acting as an underwriter) cannot rely on the exception for actively-traded securities.[26] If, however, an underwriter is itself the issuer of the security or a selling securityholder, the underwriter will be subject to the prohibitions (and limited to the exceptions) set forth in Rule 102.

9. Is an issuer subject to Regulation M trading restrictions if it is not an affiliated purchaser of a selling securityholder and is not otherwise involved in the offering?

No. The Reg M Adopting Release notes that an issuer will *not* be subject to Rule 102 in connection with a distribution of the issuer's securities effected solely by or on behalf of a selling securityholder that is not affiliated with the issuer. If, however, the issuer is an affiliated purchaser of the selling securityholder, the issuer will be subject to Rule 102 trading restrictions.

10. Can affiliates of the issuer or a selling securityholder buy securities in the offering?

Yes. The Reg M Adopting Release clarifies that Regulation M does not preclude affiliates of an issuer or selling securityholder (such as, for example, officers and directors) from purchasing securities in the offering itself.

More specifically, the Reg M Adopting Release states that securities acquired in the distribution by anyone participating in the distribution (or any affiliated purchaser) for "investment purposes" are considered to be distributed for purposes of determining the end of the applicable restricted period for the offering.[27] The phrase "for investment purposes" is not defined in this context, but most market participants believe it is sufficient for the purchasers in these cases to represent or otherwise acknowledge that they are purchasing with investment intent and not with a view to distribution or immediate resale. Although Regulation M does not mandate the imposition of resale restrictions on these purchasers, in many cases they will be subject to general offering-related lock-up agreements with the underwriters, which should also help support the investment purpose characterization.

Disclosure of these types of purchases is not required by Regulation M but is often included as a matter of practice, particularly when the purchases are of a significant size or if the purchaser is a member of company management.

11. When is a Regulation M distribution deemed to be complete in the case of a "sticky offering"?

If an underwriter is unable to sell all of its allotted securities to the public on or promptly after the pricing date (a so-called "sticky offering"), the underwriter may determine to place the unsold

securities into an investment account of the firm (sometimes referred to as the "freezer"). The definition of "completion of the distribution" in Regulation M states that securities acquired in a distribution "for investment" by a distribution participant or an affiliated purchaser of a distribution participant are deemed to be distributed. To our knowledge, however, the SEC has never issued any formal guidance as to how long such securities should be held "in the freezer" to demonstrate the requisite investment intent. Accordingly, each underwriter will typically have its own policies and procedures with respect to the minimum period the securities must be held in the freezer before they may be sold into the market and deviations from the set minimum are generally allowed only upon a showing of changed circumstances that could not have been reasonably anticipated at the time the securities were put into the freezer.[28]

12. If a shelf registration statement includes a broad description of the various means by which securities may be sold off the shelf (including through an underwritten offering), will each shelf takedown be considered a distribution?

No. The SEC confirmed in the Reg M Adopting Release that each takedown off a shelf should be individually assessed to determine whether the takedown constitutes a distribution for purposes of Regulation M. Further, the Reg M Adopting Release notes that an "issuer's description in a shelf registration statement of a variety of potential selling methods will not cause, by itself, any sales off the shelf to be treated as a distribution, unless the broker-dealer in fact uses special selling efforts or selling methods in connection with particular sales off the shelf, and the sales are of a magnitude sufficient to demonstrate the existence of a distribution."[29]

The SEC went on to note that "a broker-dealer likely would be subject to Rule 101, however, if it enters into a sales agency agreement that provides for unusual transaction-based compensation for the sales, even if the securities are sold in ordinary trading transactions."[30]

13. Can issuers continue to effect repurchases of securities under Rule 10b-18 during a Regulation M distribution?

No. In connection with the adoption of Regulation M, the SEC adopted an amendment to Exchange Act Rule 10b-18 (which provides a safe harbor under certain circumstances for repurchases by an issuer of its own common stock) that precludes reliance on the Rule 10b-18 safe harbor during the Rule 102 restricted period in distributions in which the common stock is (or is a reference security for) the security in distribution.

14. While participating in a distribution, can underwriters (i) solicit customers to purchase additional shares of the offered securities after the distribution has ended and secondary market trading in the securities begins or (ii) require customers to commit to purchase additional shares in the aftermarket as a condition to being allocated shares in the distribution?

No. The SEC staff issued Staff Legal Bulletin No. 10 on August 25, 2000 to remind underwriters and other distribution participants that such solicitations and "tie-in" arrangements are prohibited by the provisions of Regulation M (as improper inducements) and may also violate other antifraud and antimanipulation provisions of the federal securities laws.[31]

15. If an affiliated purchaser of an issuer or selling securityholder has in place a Rule 10b5-1 trading plan, can purchases under such plan continue during the restricted period for an offering?

No. Although Exchange Act Rule 10b5-1 provides a narrow safe harbor from insider trading liability, it does not provide a safe harbor from market manipulation claims, nor is purchasing activity pursuant to a Rule 10b5-1 trading plan an excepted or permitted activity under Rule 102 of Regulation M.

16. After the execution of a merger agreement, does the target company become an "affiliated purchaser" of the acquiring company?

Yes. Staff Legal Bulletin No. 9 clarifies that the target company will be subject to the restrictions of Rule 102 with respect to purchases of the acquiror's securities. Regulation M, however, generally does not apply to purchases of the target company's securities by either the target or acquiror during a merger or exchange offer (unless the acquiror's securities have a feature or term that directly ties its value to the price of the target's securities).[32]

17. In an exchange offer, are the target's securities considered reference securities for the acquiror's securities if the market price of the target's securities will be used as a factor in determining the exchange ratio for the offer?

No. SLB No. 9 states that the target's securities would only be reference securities if the relationship between the target's and acquiror's securities was a feature of the acquiror's securities themselves.

18. If the security being distributed is convertible into common stock that satisfies the criteria for the actively-traded securities exception, does the exception also apply to the security being distributed?

No. The SEC takes the view that the security in distribution is a separate security from the security into which it may be converted or for which it may be exchanged. Accordingly, a convertible security does not get the benefit of the exception for actively-traded securities that is available to the underlying common stock. The same result applies to mandatory convertible or exchangeable securities and to securities that are immediately convertible into or exchangeable for the underlying securities.

19. If an actively-traded subject security is convertible into or exchangeable for a reference security that does not satisfy the actively-traded securities exception, is the reference security subject to a restricted period under Rule 101?

No. SLB No. 9 provides that the "restricted period for a reference security is never greater than that of the subject security."

20. Do FINRA member firms need to notify FINRA when they are involved in a Regulation M distribution?

Yes. FINRA Rule 5190 requires member firms to notify and provide FINRA with certain specified information with respect to activities conducted by it in connection with a distribution subject to Regulation M (this notification requirement is typically fulfilled by the lead or managing underwriter on behalf of all the members of the underwriting syndicate). The Rule 5190 notice with respect to the determination of the restricted period must generally be filed no later than the business day prior to

the first complete trading session of the applicable restricted period, unless later notification is necessary under specific circumstances.[33] Firms must also submit a notification to FINRA under Rule 5190 that details pricing information with respect to the distribution. Such notification is generally required to be filed no later than the close of business on the next business day following the pricing of the securities. Finally, firms must immediately notify FINRA in writing if a distribution for which they have previously filed the restricted period notification has subsequently been canceled or indefinitely postponed.

Note that the FINRA Rule 5190 notification must be filed in respect of both listed and unlisted securities if a restricted period is applicable to the offering under either Rule 101 or Rule 102. Accordingly, FINRA notification is required even if the securities meet the actively-traded securities exception under Rule 101. In addition, FINRA Rule 5190 notification is required even if the offering qualifies for an exemption from filing under FINRA Rule 5110 (the Corporate Financing Rule).[34]

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Alexander F. Cohen
alexander.cohen@lw.com
+1.202.637.2284
Washington, D.C.

Kirk A. Davenport II
kirk.davenport@lw.com
+1.212.906.1284
New York

Dana G. Fleischman
dana.fleischman@lw.com
+1.212.906.1220
New York

Joel H. Trotter
joel.trotter@lw.com
+1.202.637.2165
Washington, D.C.

Endnotes

[1] Regulation M, which became effective on March 4, 1997, replaced former Exchange Act Rules 10b-6, 10b-6A, 10b-7 and 10b-21 and eliminated in its entirety the regulation of rights offerings formerly contained in Exchange Act Rule 10b-8. In adopting Regulation M, the SEC expressly rejected requests from some commenters that the rules be designed as safe harbors, determining instead that a prophylactic approach was a more effective means to protect the integrity of the offering process. *See* SEC Release No. 34-38067 (Dec. 20, 1996) (the Reg M Adopting Release).

[2] Note that characterization as a "reference security" does *not* depend on whether the subject security is immediately convertible, exchangeable or exercisable for such security, or whether the conversion, exchange or exercise may take place only after a certain contingency or condition has been met.

[3] Unlike predecessor Rule 10b-6, this definition encompasses a security underlying an equity-linked security or similar instrument that does not give the holder the right to acquire the underlying security but whose value is or may be derived from such security. However, a security will be a "reference security" only when it, or an index of which it is a component, is referred to in the actual terms of a subject security. A security of the same or a similar issuer will not be deemed a reference security merely because its price is used as a factor in determining the offering price of the security in distribution. *See* Reg M Adopting Release, n.32 and accompanying text.

[4] ADTV can be obtained from publicly available sources as long as such sources are reasonably believed to be reliable. Note that the two-month or 60-day period must be met in full as specified in the ADTV definition. If the subject security has not been outstanding for the full period specified in the ADTV definition, the ADTV calculation cannot be made and, as a result, neither the one-business day restricted period, nor the exception for actively-traded securities, would be available. This situation typically arises in connection with initial public offerings by US issuers, the distribution of a new series of debt securities, or in connection with a related "tack on" offering or re-opening of the same series of debt securities that is proposed to be made before the end of the full period specified in the ADTV definition.

[5] For purposes of Regulation M, a "business day" is a 24-hour period determined with reference to the principal market for the securities to be distributed and that includes an entire trading session for that market. Note that if a person becomes a distribution participant after the commencement of the restricted period, its activities prior to becoming a distribution participant will not be deemed to violate Regulation M (in effect, such person's restricted period will commence on the later of the applicable one- or five-day period or the time such person becomes a distribution participant).

[6] Note, however, that Exchange Act Rule 14e-5 continues to apply and may (absent an applicable exemption) prohibit purchases or arrangements to purchase the securities that are the subject of a tender offer (or any security that is immediately convertible into or exchangeable for such security) from the time of public announcement of the offer until the expiration of the offer.

[7] Pursuant to Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC proposed an amendment to Regulation M in April 2011 that would remove the references to credit ratings in Rules 101 and 102 and replace them with new standards that focus instead on the trading characteristics of the covered securities. *See* SEC Release No. 34-64352 (Apr. 27, 2011). Briefly, the exception would (if adopted as proposed) exempt from Regulation M's trading prohibitions nonconvertible debt securities, nonconvertible preferred securities and asset-backed securities that (i) are liquid relative to the market for that asset class, (ii) trade in relation to general market interest rates and yield spreads and (iii) are relatively fungible with securities of similar characteristics and interest rate yield spreads.

[8] Note that this exception is *not* available in a distribution of a Rule 144A-eligible security that includes accredited investors. For this reason, following the adoption of Regulation M, distributions of Rule 144A-eligible securities are typically made solely to QIBs and do not include a side-by-side private placement or so-called "Section 4(1½)" offering to institutional accredited investors.

[9] Although this exception is generally thought of as applying solely to transactions that satisfy the exemptions from Securities Act registration provided by Rule 144A and Regulation S, it also encompasses, for example, direct placements by issuers that are not eligible for Rule 144A (which applies to resale transactions) but instead satisfy the exemption from Securities Act registration provided by Section 4(a)(2) or Regulation D, provided that the securities are eligible for resale under Rule 144A and are offered and sold only to persons that are, or are reasonably believed to be QIBs or non-US persons under Regulation S.

[10] Although Rule 102 does not contain an exception for actively-traded securities issued by the issuer or an affiliate of the issuer, transactions in reference securities (including securities into which the security being distributed is convertible or exchangeable) that are actively-traded securities and issued by an unaffiliated entity are exempt from Rule 102's trading restrictions.

[11] *See* note 7 above with respect to proposed changes to the investment grade rating element of this exception.

[12] "Stabilizing" is 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.

[13] A "syndicate covering transaction" is the placing of any bid, or the effecting of any purchase, on behalf of the syndicate (or a sole distributor) to reduce a short position created in connection with the offering. Note that the exercise of an overallotment option is

not considered a syndicate covering transaction. *See* SEC Staff Legal Bulletin No. 9 (issued Oct. 27, 1999 and revised Sept. 10, 2010) (SLB No. 9).

[14] The imposition of a "penalty bid" allows the managing underwriter to reclaim a selling concession from a syndicate member when the securities originally sold by the syndicate member are repurchased in syndicate covering transactions.

[15] *See* Reg M Adopting Release, text accompanying n.126.

[16] In connection with the adoption of Regulation M, certain amendments were made to Item 502(d) (with respect to the content of the "stabilizing legend" placed on the prospectus cover) and Item 508 (with respect to the disclosure in the "Plan of Distribution" section of the prospectus of general information regarding stabilizing and aftermarket activities) of SEC Regulations S-K and S-B. Rule 17a-2 under the Exchange Act was also amended to require that managing underwriters keep records of syndicate covering transactions and penalty bids in addition to the information currently required with respect to stabilizing transactions.

[17] Prior to its amendment in 2007, Rule 105 limited only "covering" transactions (*i.e.*, a short seller was prohibited from using securities purchased in a registered offering to cover short sales entered into during the pre-pricing period). According to statements made by the SEC at the time the amendments to Rule 105 were adopted, the changes to the rule were intended to (i) put an end to the progression of trading strategies designed to hide covering activity that was prohibited by Rule 105, (ii) streamline compliance with Rule 105 and (iii) facilitate enforcement of Rule 105. *See* SEC Release 34-56206 (Aug. 6, 2007) (the Rule 105 Release).

[18] The SEC states in the Rule 105 Release that, although it chose not to cover derivative trading strategies in the amended rule, it will continue to monitor the use of such strategies (including the extent to which such strategies are the functional equivalent of equity trading covered by the rule) and reminds firms that, even if a transaction or series of transactions does not violate Rule 105, it remains subject to the general antifraud and antimanipulation provisions of the securities laws.

[19] The SEC has acknowledged that this element of the exception may prevent its use in a "truly 'overnight deal' when an offering commences after the close of regular trading on the day of pricing" because such person will not have time to effect a qualifying covering purchase. *See* Rule 105 Release, n.58 and accompanying text.

[20] The exception for separate accounts was based on a similar exception for "aggregation units" contained in Rule 200(f) of SEC Regulation SHO. Unlike the aggregation unit exception in Regulation SHO, however, which is available only to broker-dealers, the Rule 105 exception may be used by *any entity* that satisfies the exception's requirements.

[21] Rule 105(b)(2). The SEC notes in the Rule 105 Release that the term "accounts" for purposes of this exception is used as a general term that may encompass the many types of accounts referenced in the various comment letters received in connection with the original proposal, including "portions of a particular fund," "units," "departments" and "identifiable divisions." *See* Rule 105 Release, n.64. The SEC also includes in the Rule 105 Release a non-exhaustive list of factors that can be used to demonstrate "separateness."

[22] *See* Reg M Adopting Release, n.43 and accompanying text.

[23] *See* Reg M Adopting Release, n.24 and accompanying text.

[24] Note that Regulation M eliminated the additional restriction imposed by predecessor Rule 10b-6 that, in connection with the use of Rule 139 research, earnings estimates cannot be increased and recommendations cannot be upgraded. Note also that Rule 102 does not have a comparable exemption for Rule 138/139 qualifying research for issuers and selling securityholders and their affiliated purchasers.

[25] The Staff of the SEC's Division of Trading and Markets has preliminarily informed us that they do not believe Regulation M conflicts with the JOBS Act mandate to eliminate post-IPO effective date research restrictions since Regulation M does not technically restrict research for a "prescribed period of time" following an offering. They are continuing to consider the issue raised with respect to follow-on and secondary offerings of non-actively-traded securities, but believe they may be limited in their ability to act by the JOBS Act reference in this regard to IPOs.

[26] *See also* SLB No. 9. Note that the non-affiliated syndicate members, however, can utilize the actively-traded securities exception.

[27] The Reg M Adopting Release notes that this interpretation codifies the approach taken by the SEC staff in the *Letter Regarding VLI Corporation*, No-Action Letter (avail. Oct. 17, 1983). Whether or not affiliated purchasers of underwriters or other distribution participants can purchase in the offering may, however, be constrained by other rules and regulations, including, *e.g.*, those applicable to member firms of FINRA.

[28] *See* FINRA Rules 5130 and 5141 for certain restrictions that limit the ability of underwriters and their affiliates to purchase (or retain) securities in certain types of offerings. *See also* SEC Division of Corporation Finance Compliance and Disclosure Interpretations, Securities Act Rules, Rule 144, Question 128.02.

[29] Reg M Adopting Release, n.47.

[30] Reg M Adopting Release, text following n.48.

[31] *See also* SEC Release 34-51500 (Apr. 7, 2005) (Commission Guidance Regarding Prohibited Conduct in Connection with IPO Allocations).

[32] Note, however, that Exchange Act Rule 14e-5 will continue to apply and may prohibit purchases of the target company's securities by the acquiror during a tender or exchange offer for the target's securities.

[33] *See* FINRA Regulatory Notices 12-19 (Apr. 2012) and 08-74 (Dec. 2008); *see also SEC Regulation M-Related Notice Requirements Under FINRA Rules Frequently Asked Questions* (the FINRA Reg M FAQs), *available at* http://www.finra.org/Industry/Regulation/Guidance/P118758. Similar notification requirements may also apply under the rules of the NYSE, NASDAQ and other national securities exchanges. The FINRA Reg M FAQs remind firms that, even if a later notification to FINRA is warranted under the circumstances, in no event may the notification be filed later than the close of business on the day the distribution terminates. *See* FINRA Reg M FAQS, Response to Q1.34.

[34] *See* FINRA Reg M FAQs, Response to Q1.4.