



Securities Industry Association

120 Broadway • New York, NY 10271-0080 • (212) 608-1500 • Fax (212) 968-0703

December 12, 2003

Annette Nazareth
Director, Division of Market Regulation
U.S. Securities & Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Discussions of SEC Litigation regarding Aftermarket Interest in the IPO Process

Dear Annette:

On behalf of SIA's Federal Regulation and Capital Markets Committees, I want to thank you for taking the time to meet with us on November 14 to discuss the industry's questions and concerns regarding IPO allocation practices. These meetings are critically important to us in providing certainty in the regulatory environment for the securities industry and we cannot underscore enough how much we appreciate your attention to this timely issue. At the end of the meeting, you requested that SIA identify the statements from the Enforcement Release in the J.P. Morgan matter that cause us particular concern. Part I of this letter responds to that request. Part II amplifies the discussion at the meeting on the importance to the IPO process of gathering information concerning aftermarket interest.

In its J.P. Morgan Release, the Commission generally characterized Regulation M as prohibiting underwriters from attempting to induce customers to bid for or purchase an offered security "in the aftermarket." However, consistent with its language and prior application, Regulation M prohibits only attempts by distribution participants to induce customers to make bids or purchases "during the [pre-IPO] restricted period" that ends upon completion of the distribution of the shares. Regulation M reaches aftermarket manipulation by prohibiting the solicitation of aftermarket tie-in agreements – i.e., agreements whereby customers agree to buy a specified amount of additional stock in the aftermarket (or to sell the allocated stock back to the underwriter at a specified price) in exchange for a promised allocation. Regulation M reaches such aftermarket tie-in

agreements, or "contracts," by virtue of the statutory definition of "purchase," which includes a "contract to purchase."

I. Analysis of Certain Statements in SEC Litigation Press Release 2003-129.

SIA believes certain language in the J.P. Morgan Release goes well beyond previously established law and we are concerned about the impact on legitimate price discovery and allocation efforts.

- A. **"J.P. Morgan solicited customers to provide information about whether and at what price and in what quantity they intended to place aftermarket orders for IPO stock."**

Comment: This language causes us the most concern in that it may be interpreted as extending the ban on solicitations of tie-in agreements or tied-in orders to more generalized questions regarding an investor's potential market purchases. The gathering of information from the institutional marketplace is an essential element of the book-building process for raising capital. It has been longstanding practice, both before and after the "bubble," to obtain information about a potential investor's valuation of and interest in the company. As part of this information-gathering process, the market "speaks" and valuable information is obtained to help price and size a deal, and determine potential long-term investors.

Intentional solicitation of aftermarket tie-ins from potential customers is clearly prohibited. However, it does not follow that a discussion regarding possible aftermarket interest, including an indication of price levels at which the client might be interested in buying, equates to a solicitation of a tie-in agreement. A solicitation should not be presumed from expressions of interest in IPO shares and in aftermarket shares.

An examination of the surrounding facts and circumstances is necessary to determine whether questions about aftermarket interest were asked for an illicit purpose, such as to extract a promise to purchase in exchange for an

allocation. Evidence that the underwriter solicited firm aftermarket orders in exchange for promised allocations would be probative.

Evidence that the underwriter solicited firm aftermarket orders in exchange for promised allocations, in combination with action to carry out such an agreement, such as evidence that the underwriter executed the solicited orders in the aftermarket without further instruction from the customers, would also be probative.

We believe that the staff should clarify that an inquiry into a potential investor's interest in the IPO shares and the aftermarket and at what price levels is not a violation of Regulation M so long as no firm orders are taken and there is no implicit or explicit agreement to buy in the aftermarket as a condition to an allocation in the IPO. SIA supported proposed rule language in NASD Notice to Members 02-55 that would have preserved the distinction between solicitations of aftermarket interest in the quid pro quo context from due diligence inquiries regarding a potential customer's interest that are routinely made during the book-building process.¹

- B. "J.P. Morgan solicited aftermarket interest from certain customers who J.P. Morgan knew had no interest in owning stock of the IPO companies long term. J.P. Morgan knew that some of these customers usually or always flipped (immediately sold) their IPO allocations. Nevertheless, J.P. Morgan expected these customers to follow through and buy in the aftermarket when they provided aftermarket interest. A number of these customers bought in the aftermarket and then sold their allocation or closed out their entire position within days of the IPO's."**

Comment: It is SIA's view that soliciting aftermarket *orders* is distinct from soliciting *information* about a client's possible interest in the IPO shares in the aftermarket. Information about expected aftermarket

¹ See Footnote 3 *infra* and related discussion.

valuations of an offered security can be quite relevant to the pricing of the offering even if such information comes from accounts that are generally known to have a short-term investment perspective. Such accounts often have very sophisticated valuation methodologies and their feedback may thus be very valuable. Moreover, even accounts that may have a short-term perspective in most securities can often have a genuine, longer term investment interest in particular offerings, and thus, past investment patterns do not guarantee that the account will be a "trading" account in every deal.

Past actions with respect to flipping securities in one offering do not necessarily indicate that an investor will flip the shares in the current offering. While an underwriter is seeking as many core, stable (long term) investors as possible, it does not mean that other investors are precluded from receiving an allocation. Even if past behavior was predictive of behavior in the current offering, not all of the shares can be or necessarily must be allocated to core stable investors. Thus, the fact that an investor has been a flipper in the past or indicates that they may be a flipper in the current offering should have no bearing on the appropriateness or legality of soliciting or receiving information from such an investor. In addition, the mere fact that an investor who has flipped in the past or indicates a shorter-term interest in the current offering is allocated shares, then buys more shares in the after-market and sells them, should not in and of itself be probative of any illegal activity by the broker-dealer.

- C. "J.P. Morgan accepted, and in at least one instance sought, aftermarket interest from certain customers who said they intended to purchase an amount of shares in the aftermarket equal to the size of their IPO allocation ("1 for 1") or intended to purchase specific amounts of shares in the aftermarket that were pegged to different allocation amounts without any reference to a fixed total position size. Some customers who gave this type of aftermarket interest received large allocations even though this aftermarket interest did not provide information as to a customer's desired position size or whether a customer intended to be a long-term holder."

Comment: This language raises serious concerns because a successful capital-raising effort assumes the gathering of information. The underwriter, through its sales force, is not in a position to control the response of a potential customer to legitimate inquiries into aftermarket interest. Whether or not the firm acted illegally in seeking this information should be determined by objective evidence of the firm's conduct, knowledge or intention, not by the response of the customer. Thus, evidence of a customer's response to an underwriter's aftermarket inquiry should not by itself support any allegation of wrongdoing by the firm.

Also, we are concerned by the language in this section suggesting that the customer's *omission* of certain information is relevant to the legitimacy of the underwriter's inquiry. A customer's potential "total position size" or intention to be a long-term holder is information that is certainly of interest and importance to the underwriter. However, the language in the release seems to suggest that an underwriter's failure to ask for, or a customer's failure to provide, this information is somehow indicative of wrongdoing.

- D. "After the restricted period, J.P. Morgan solicited aftermarket orders by making follow-up calls to customers who had previously indicated aftermarket interest. Further, J.P. Morgan often tracked whether customers followed through on their aftermarket interest and actually purchased in the aftermarket."

Comment: It is not a violation of Regulation M for a broker-dealer's sales personnel, after the restricted period, to inquire of a customer who has previously expressed an interest in owning a particular stock whether that customer is interested in purchasing more of the stock. Indeed, this is the normal course of business in the secondary market, where customers indicate interest and salespersons follow up.

Calls made to "enforce" previously made aftermarket commitments, particularly in instances where these commitments are characterized as

"obligations" or "promises" of the customer by employees of the firm, may be probative of a tie-in agreement. On the other hand, the fact that an order had to be solicited at all may demonstrate that there was in fact no secret agreement with the customer to purchase in the aftermarket as a condition for an allocation. Finally, the fact of any "tracking" in and of itself should not be suggestive of a violation of Regulation M.

II. Value of Aftermarket Interest

Information regarding a potential customer's aftermarket interest helps the underwriter gauge the quantity and quality of the demand for the offering at various price levels. This in turn helps to price size and allocate offering shares and reduces aftermarket volatility.

In an IPO, the underwriter must consider the interests of the following stakeholders:

- The interests of the owners of a company in the success of an offering and in the future growth prospects of the company.
- The interests of investors who also want to capture the future growth prospects of the company, but only after purchasing the new shares at a discount that reflects the risk of investing in a company new to the public markets.
- The likely behavior of buyers and sellers once the shares begin trading, including the possibility that some IPO purchasers will seek to maximize any short-term gain by immediately selling the IPO shares in the aftermarket.
- The interests of other investors, like mutual funds, that want to buy and hold sizable positions of shares of a new company because the company fits their investment profile. The interests of these longer-term investors can be hurt when the price of the new shares declines due to heavy selling by short-term investors.

The underwriter's role is to price, size and allocate IPO shares in a way that balances these competing economic interests in light of existing market conditions at a time when supply and demand have not yet had a chance to determine an efficient market price for a new security.

Underwriters gather information from potential purchasers of IPO shares during the marketing phase in order to help the underwriter price and size the offering or place shares with long-term investors. This is an interactive and dynamic process with institutional investors. The dialogue may involve an expression by a potential customer of its after-market interest, or an inquiry by the underwriter into the customer's interest in the after-market. The dialogue may also involve a discussion of the investor's valuation views, methodologies, and/or price limits. Most helpful are expressions of aftermarket interest that include an indication of the price levels at which the customer might be interested in buying. All of this information - aftermarket interest; valuation views, models and price targets; and, particularly interest at various levels - helps the underwriter gauge the quantity and quality of the demand for the offering. The underwriter seeks to find out at what price the investor sees the stock trading over the near and long term, given the investor's own valuation beyond the preliminary price range printed in the preliminary prospectus. And, recognizing that in a hot IPO there is more demand than supply, the underwriter would want to know if the client might buy or sell in the aftermarket if it does not get a certain allocation size.

Potential aftermarket interest is also one factor used to identify the clients who may be long-term investors and to allocate shares to as many such investors as practicable. Among other criteria used by underwriting firms are: the size of an account's anticipated long term investment, an account's track record of investment in similar issues, an account's apparent interest in the issuer as evidenced by attendance at roadshows, the account's assets under management, and the existing or potential business relationship between an account and the firm.

It is worth noting that the SEC has previously recognized the importance of underwriter inquiry into a potential customer's aftermarket interest. In the 1963 Market Study, the SEC observed that to combat flipping², "underwriters attempt to place stock where long-term investment was likely rather than to place it where it was likely to sell their allotments in the immediate aftermarket." H.R. Doc. No. 1, 88th Cong., 1st Sess. 523, 526. In proposing Regulation M, the SEC stated that one of the objectives of [anti-flipping measures] is to encourage syndicate members to sell

² The SEC recognized early on that "flipping" was a leading cause of "market disturbances" and "market abnormalities" (SEC Release No. 34-2446 (March 18, 1940)). Courts have also observed that the collective action of flippers can cause a glut of shares to enter trading, depressing the stock price and disrupting the efficient distribution of securities." [Friedman p.4]

securities to persons who intend to hold them rather than engage in short-term profit making." [Proposing Release at 1740]. In order to identify the "long-term" investors and "persons who intend to hold stock," underwriters ask questions of potential investors that include inquiries into aftermarket interest.

The SEC has also specifically addressed the practice of underwriter inquiry into a potential customer's aftermarket interest in an enforcement action without suggesting it is prohibited. In 2002, the SEC brought an enforcement action against Credit Suisse First Boston ("CSFB"). Among the criteria the SEC describes CSFB as using to make allocation decisions is "the long or short term interest of an account in an issuer." [Complaint at para.13]. The SEC nowhere suggests that an underwriter's inquiry into an account's interest is illegal. Interestingly, the SEC Complaint offers perhaps the single best reason why an underwriter might want to seriously probe a customer for information about the customer's potential interest. The Complaint describes certain customers who created false identities, misrepresented their assets, and otherwise engaged in deceptive practices in an effort to obtain IPO allocations. [Complaint at 44]. Such misrepresentations by potential investors can cause underwriters to misread demand and assign a price to a securities offering that does not properly reflect investors' valuation of the company. Additionally, such misrepresentations can produce unanticipated buying and selling which can cause excessive volatility that harms investors and the issuer.

Finally, recent rulemaking efforts have sought to keep the focus on prohibited conduct while recognizing legitimate inquiry into aftermarket interest. In 2002, the NASD proposed rules that specifically did not prohibit solicitations of information from customers. [NASD NTM 02-55] The NASD rule would have preserved the distinction between certain prohibited solicitations of aftermarket orders and solicitations of information about potential investor interest in the stock. Specifically, the proposed rule would have required a showing that the underwriter requested an aftermarket purchase from a customer as a condition to being allocated shares in the IPO. SIA supported this provision in comments filed with the NASD.³

³ "SIA supports this provision as appropriate to deterring manipulation in the aftermarket. We believe the language of the proposed rule appropriately distinguishes solicitations of aftermarket interest in the *quid pro quo* context, from due diligence inquiries regarding a potential customer's interest that are routinely made during the book-building process. This due diligence exercise is essential to pricing and selling the transaction, and balancing supply and demand in the aftermarket, all of which ultimately reduce risks for issuers and investors alike." Letter to Barbara Sweeney, Corporate Secretary, NASD, from Kenneth L.

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Director, Division of Market Regulation
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Unfortunately, and without meaningful explanation, the NASD chose to withdraw this provision from the version of the rule proposal it recently filed with the SEC.

In May 2003, the NASD/NYSE IPO Advisory Panel also drew a clear distinction between permitted and impermissible activities. In recommending a rule to "redress and prevent IPO Laddering," the panel stated: "collecting information about investors' long-term interest in, and valuation of, a prospective issuer is an essential part of the bookbuilding process." (IPO Report p.6).

III. Conclusion

We appreciate the opportunity to be heard on this important matter and believe clarification will be critical to removing the doubts among practitioners about the extent of legitimate aftermarket inquiry. We would also welcome the opportunity to meet with you again to discuss this issue and to provide you with any additional information you may require. Please contact Scott Kursman, SIA Vice President & Associate General Counsel, at 212-618-0508, with any questions or comments.

Very truly yours,

Joseph Polizzotto
Ad Hoc Committee on IPO Allocation

Richard G. Ketchum
Ad Hoc Committee on IPO Allocation

cc: Alan Beller, Director Division of Corporation Finance
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Antonia Chion, Associate Director, Division of Enforcement
Larry Bergmann, Senior Associate Director, Division of Market Regulation
Amy Starr, Senior Special Counsel, Division of Corporation Finance
James Brigagliano, Assistant Director, Division of Market Regulation
Joan Collopy, Division of Market Regulation

Josselyn, Chairman, Capital Markets Committee, SIA (September 24, 2002) available at http://www.sia.com/2002_comment_letters/pdf/ipo.pdf