

THE REVIEW OF SECURITIES & COMMODITIES REGULATION

AN ANALYSIS OF CURRENT LAWS AND REGULATIONS
AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 43 No. 1 January 6, 2010

"AT-THE-MARKET" OFFERINGS – IMPLICATIONS UNDER REGULATION M

The volatility of the financial markets in the last 18 months has contributed to increased interest in "at-the-market" offerings as a means for public companies to opportunistically and incrementally raise capital. These programs raise a number of issues under the securities laws, including the need to navigate the requirements of Regulation M. The authors highlight the issues under Regulation M that should be considered before commencing an at-the-market offering and suggest possible measures to address certain of these issues.

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The turmoil in the financial markets over the past 18 months and the resulting liquidity and capital resource constraints faced by public companies has been well documented. The continuing market volatility has seen "at-the-market," or "ATM," offerings emerge as an increasingly popular alternative to large public underwritten offerings following the relaxation of certain restrictions brought by the securities offering reforms.¹ "ATMs" or "equity dribble out programs" enable issuers to offer and sell their equity securities through one or more registered broker-dealers in a series of public, registered transactions effected over an extended period of time and at the then-prevailing market prices. ATM

programs offer certain advantages in a volatile equity market, including the ability of an issuer to raise capital in an incremental fashion, while avoiding many of the risks associated with large underwritten offerings through the low profile, best-efforts nature of the offering.

The size, duration and other details of an ATM offering may vary from issuer to issuer, but certain basic elements remain fairly constant. Because ATM offerings are conducted pursuant to Rule 415(a)(iv) under the Securities Act of 1933, the issuer must be eligible to register primary offerings on Form S-3. Assuming it meets the requisite criteria, the issuer enters into a sales agency agreement with a broker-dealer, pursuant to which the firm agrees to sell shares on behalf of the issuer from time to time, as instructed, subject to a specified maximum number of shares and/or maximum

¹ The securities offering reforms eliminated the volume limitation, which restricted at-the-market offerings to 10% of the issuer's public float and the requirement to identify the underwriter in the registration statement prior to effectiveness or to file a post-effective amendment to add an underwriter. See Rel. No. 33-8501 (2004).

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offering price.² Sometimes characterized as the inverse of a share repurchase program, the typical ATM program allows the issuer to determine the timing, amount, and minimum offering price for shares sold over the life of the program, which may run anywhere from several weeks to several years.

As with a medium-term note program, the sales agreement will provide for the periodic delivery of auditor's comfort letters, opinions of counsel and officer's certificates, as well as regular bring down of due diligence. The commencement of an ATM program requires the preparation of a brief prospectus supplement, which is filed together with a Form 8-K to include the sales agreement as an exhibit. Issuances under an ATM program are disclosed at the end of each quarter in the issuer's periodic reports on Forms 10-Q and 10-K, and also in quarterly prospectus supplements.

While ATM offerings afford issuers an additional means to raise capital, particularly during uncertain times, this flexibility does not come without its traps for the unwary. As further evidenced by the discussion below, one such potential trap is the Securities and Exchange Commission's Regulation M, which restricts the activities of the issuer and participating broker-dealers in connection with certain offerings of securities. This article provides a general overview of Regulation M's purpose and various prohibitions, focusing particularly on the potential implications for ATM offerings. It also suggests some measures an issuer and its broker-dealer agent(s) might take to minimize certain of those implications.

REGULATION M AND ATM PROGRAMS

It is a basic premise of the U.S. securities laws that securities should not be distributed in a market stimulated by the activities of persons having an interest in the distribution. In order to ensure that securities are distributed in a market free from manipulation, the SEC

adopted Regulation M.³ Regulation M consists of six rules: Rule 100, which sets forth applicable definitions, and Rules 101 through 105, which collectively are intended to prevent persons having an interest in an offering (*e.g.*, the issuer, the underwriters or placement/sales agents, and certain related parties) from artificially conditioning the market for the securities being distributed. The various exceptions to the general prohibitions of the rules are intended to permit an orderly distribution of securities and limit disruption to the market.

Certain of Regulation M's prohibitions and restrictions – specifically, those set forth in Rules 101 through 103 of Regulation M – apply only to those public or private offerings that constitute a “distribution,” as defined in Rule 100 of Regulation M,⁴ while others – specifically, the stabilization provisions of Rule 104 of Regulation M – apply to almost all

³ Regulation M, which was adopted by the SEC in December 1996, became effective on March 4, 1997. *See* Rel. No. 34-38067 (1996). Regulation M replaced former Rules 10b-6, 10b-6A, 10b-7, 10b-8, and 10b-21 under the Exchange Act. The SEC has since adopted (in 2008) a *new* Rule 10b-21 under the Exchange Act, which is directed at naked short-selling activity.

⁴ The term “distribution” is defined in Rule 100 to include any offering of securities, whether or not registered under the Securities Act, that is distinguished from ordinary trading transactions by both the “magnitude” of the offering and the presence of “special selling efforts and selling methods.” There is no safe harbor from Regulation M's “distribution” definition, although in 1982 the SEC did propose a safe harbor under former Rule 10b-6 for transactions in compliance with the then-applicable volume and manner of sale provisions of Securities Act Rule 144. *See* Rel. No. 34-18528 (1982). While the SEC ultimately chose not to adopt the proposed safe harbor, its rationale for declining to do so was apparently prompted by commenters' concerns that the proposed safe harbor would come to serve as a prescriptive standard, rather than any serious concern on the part of the SEC that offerings satisfying the proposed safe harbor conditions would nonetheless implicate the “magnitude” and “special selling efforts/methods” elements of the distribution definition. To date, the distribution analysis remains inherently facts and circumstances intensive. *See also infra* “What is a Distribution for Purposes of Rules 101 and 102?”

² The broker-dealer typically acts in an agency capacity (although in some situations may act as principal) and is paid commissions (commonly in the range of 1-3% of the gross offering proceeds) for agent sales under the program.

corporate securities offerings.⁵ By contrast, Rule 105 of Regulation M applies only to SEC-registered offerings, and offerings pursuant to Regulations A or E, of equity securities for cash that are conducted on a “firm commitment” basis. As further outlined below, the potential Regulation M implications for an ATM offering therefore depend not only on the circumstances of the individual offering, but also on the particular rule in question.

Rule 102 -- Restrictions on the Activities of Issuers, Selling Security Holders, and Their Respective Affiliated Purchasers

General scope and prohibition. Rule 102 of Regulation M governs the activities of an issuer or selling security holder during a public or private “distribution” of securities effected on its behalf, as well as the activities of certain parties deemed to be “affiliated purchasers” of the issuer or selling security holder.⁶ In general, Rule 102 prohibits persons subject to the rule from bidding for, purchasing, or attempting to induce any other person to bid for or purchase the security that is the subject of the distribution (the “subject security”), or any “reference security,”⁷ during a specified “restricted period.” Notably, any bids and

purchases by or on behalf of an issuer plan (e.g., a retirement plan or a stock purchase and dividend reinvestment plan) will be attributed to the issuer unless effected by an independent agent.⁸

Restricted period. The commencement and duration of the restricted period to which an issuer or selling security holder and any of their respective affiliated purchasers are subject will depend upon the nature of the “distribution” and the characteristics of the particular security.⁹ In a traditional underwritten offering, the commencement of the restricted period depends upon the average daily trading volume (“ADTV”) value of the particular security, as well as the issuer’s public float value.¹⁰ For securities with an ADTV value of at least

⁵ As discussed *infra*, Rule 104 does not apply to: (i) offerings of “exempted securities;” or (ii) transactions in Rule 144A-eligible securities in connection with an offering of such securities made exclusively to qualified institutional buyers (“QIBs”) in transactions exempt from registration under the Securities Act, and to non-US persons during a concurrent Rule 144A offering to QIBs.

⁶ Pursuant to Rule 100, an “affiliated purchaser” includes any person acting in concert with an issuer, selling security holder, or “distribution participant” in connection with the acquisition or distribution of the security being distributed (the “subject security”) or any “reference security,” as defined in Rule 100. It also includes any affiliate that controls those persons’ purchases of such securities, or whose purchases are controlled by, or under common control with, such persons. Subject to certain exceptions, any affiliate that regularly purchases securities for its own account or the account of others, or that recommends or exercises investment discretion with respect to the purchase or sale of securities, is also deemed to be an “affiliated purchaser” of the entity with which it is affiliated.

⁷ A “reference security” is defined in Rule 100 to include any security into which the subject security “may be converted, exchanged, or exercised, or which, under the terms of the subject security, may in whole or significant part determine the value of the subject security.” For example, in a distribution of convertible debt, the convertible bonds would be the subject security, and the underlying common stock would be the reference security.

⁸ See Rule 102(c)(2). As defined in Rule 100, a “plan” means “any bonus, profit-sharing, pension, retirement, thrift, savings, incentive, stock purchase, stock option, stock ownership, stock appreciation, dividend reinvestment, or similar plan; or any dividend or interest reinvestment plan or employee benefit plan as defined in [Securities Act Rule 405].” An “agent independent of the issuer” is defined in Rule 100 to mean “a trustee or other person who is independent of the issuer.” To be deemed “independent” of the issuer, the agent must not be an affiliate of the issuer. In addition, an agent will not be deemed “independent” unless “[n]either the issuer nor any affiliate of the issuer exercises any direct or indirect control or influence over the prices or amounts of the securities to be purchased, the timing of, or the manner in which, the securities are to be purchased, or the selection of a broker or dealer (other than the independent agent itself) through which purchases may be executed.” The issuer (or its affiliate) is, however, permitted to make certain periodic adjustments to certain plan details without causing the agent to fail the “independence” test. Specifically, the issuer (or its affiliate) is permitted to, no more than once in any three-month period, revise “the source of the shares to fund the plan, the basis for determining the amount of its contributions to a plan, or the basis for determining the frequency of its allocations to a plan, or any formula specified in a plan that determines the amount or timing of securities to be purchased by the agent.”

⁹ See the definition of “restricted period” in Rule 100.

¹⁰ Rule 100 defines “ADTV” to mean “the worldwide average daily trading volume during the two full calendar months immediately preceding, or any 60 consecutive calendar days ending within the 10 calendar days preceding, the filing of the registration statement; or, if there is no registration statement or if the distribution involves the sale of securities on a delayed basis pursuant to [Securities Act Rule 415], two full calendar months immediately preceding, or any consecutive 60 calendar days ending within the 10 calendar days preceding, the determination of the offering price.” Public float value is determined in the manner set forth on the front page of Form 10-K.

\$100,000, where the issuer's common equity securities have a public float value of at least \$25 million, the restricted period will commence one business day prior to the pricing of the subject security.¹¹ For all other securities, the restricted period will begin five business days prior to the pricing of the subject security. In all cases, the restricted period continues until the distribution is completed.¹²

Excepted securities. Certain types of securities are excepted from the prohibitions of Rule 102, such that persons subject to Rule 102 may continue their trading activities in such securities without regard to the restrictions and limitations otherwise imposed by the rule. These securities are: (a) reference securities with an ADTV value of at least \$1 million that are issued by an issuer whose common equity securities have a public float value of at least \$150 million (provided such reference security is not issued by the issuer, or any affiliate of the issuer, of the subject security);¹³ (b) asset-backed securities, and non-convertible debt and preferred securities, that are in each case rated investment grade; (c) "exempted securities," as defined in Section 3(a)(12) of the Exchange Act; and (d) face-amount certificates and redeemable securities issued by an open-end management investment company or unit investment trust.¹⁴

Excepted activities. Rule 102 also excepts various activities from the general prohibitions of the rule, such

that the issuer or selling security holder and its affiliated purchasers may engage in these activities during the restricted period. Among other things, the rule contains exceptions for certain odd-lot transactions, exercises of securities, and unsolicited purchases.¹⁵

ATM program implications. If an ATM program is deemed to involve a "distribution" for purposes of Regulation M, the issuer could find itself subject to a very extended Regulation M restricted period, given that "pricing" occurs each time a program sale is effected. This is true regardless of the issuer's public float value and/or the security's ADTV value. The rule's excepted security provisions are unlikely to prove relevant to the issuer in connection with an ATM program distribution, and the excepted activities, while of some potential value, may afford insufficient relief if the restrictions extend over the course of many weeks or even months. Indeed, even if the issuer is not itself interested in effecting purchases during the pendency of the ATM program (e.g., conducting strategic open market buybacks),¹⁶ an extended Regulation M restricted period could prove problematic for other reasons. For example, it could serve to restrict any bids and purchases by or on behalf of issuer plans, unless effected by an independent agent. It could also restrict executives' ability to effect purchases for their own accounts, regardless of whether such purchases are pursuant to a Rule 10b5-1 plan, if the executives are considered "affiliated purchasers" of the issuer.¹⁷

¹¹ "Business day" is defined in Rule 100 to mean "a 24-hour period...that includes a complete trading session [in the subject security's principal market]."

¹² For other types of distributions, the restricted period may be calculated somewhat differently. For example, in the case of a distribution involving a merger, acquisition, or exchange offer, the restricted period begins on the day proxy solicitation or offering materials are first disseminated to the target company's security holders and continues through to the time of the target shareholders' vote. If not subsumed within the foregoing period, an additional restricted period would begin one or five business days prior to any valuation period and continue through to the completion of such period. See the definition of "restricted period" in Rule 100; see also Rel. No. 34-38067 (1996), at text accompanying n.52; SEC Staff Legal Bulletin No. 9 (last revised as of April 12, 2002), available at <http://www.sec.gov/interp/leg/mrslb9.htm>.

¹³ For example, this exception would be available in the case of a distribution of equity-linked notes (the subject security) linked to the common stock (the reference security) of an issuer unaffiliated with the issuer of the notes, provided the common stock satisfies the specified criteria.

¹⁴ Rule 102(d)(1)-(4).

¹⁵ Rule 102(b). It also excepts transactions in Rule 144A-eligible securities, or any reference security, during a distribution of the Rule 144A-eligible securities, provided that sales of such securities within the United States are made solely to: (i) QIBs, or to persons reasonably believed to be QIBs, in transactions exempt from registration under the Securities Act; and (ii) persons not deemed to be "U.S. persons" for purposes of Regulation S, during a concurrent Rule 144A distribution to QIBs.

¹⁶ While Exchange Act Rule 10b-18 provides a limited safe harbor from manipulation liability in connection with certain issuer repurchases of common equity securities, provided the conditions of the rule are satisfied, the safe harbor is not available during the restricted period of a distribution subject to Rule 102 of Regulation M. See Rule 10b-18(a)(13)(i). Moreover, repurchases in accordance with Rule 10b-18 are not an excepted activity under Rule 102.

¹⁷ Exchange Act Rule 10b5-1 provides a limited safe harbor from insider trading liability, but not from market manipulation liability, if the conditions of the rule are satisfied. The rule provides no safe harbor from Regulation M, nor is trading activity pursuant to a Rule 10b5-1 plan an "excepted activity" under Rule 102 of Regulation M.

Issuers of any size should carefully consider these issues and may wish to undertake various proactive steps to mitigate the potential negative implications prior to commencing an ATM program. For example, issuers may wish to verify that their plan agents qualify as “independent” within the meaning of Regulation M. In addition, or in the alternative, an issuer may wish to impose various specific conditions and limitations on ATM program sales, with a view to mitigating the risk that the ATM program will be deemed to be a “distribution” in the first instance.¹⁸

Actively traded issuers (*i.e.*, those meeting the minimum \$150 million public float value and \$1 million ADTV value criteria of Rule 101(c)(1), discussed *infra*) should keep in mind that their sales agents may be less concerned with the “distribution” analysis and therefore may not necessarily embrace all efforts to constrain sales tactics and/or sales volume. By the same token, non-actively traded issuers should be aware that many securities firms have informal policies confining their ATM program engagements to actively traded issuers. Indeed, of the sample of ATM program sales agency agreements reviewed by the authors, the vast majority included express representations as to the issuer’s actively traded status for purposes of Regulation M. Non-actively traded issuers may experience more difficulty identifying firms willing to accept an ATM program engagement. If they are able to engage a securities firm for such an offering, however, both the issuer and the sales agent(s) will have a vested interest in taking steps to protect against the program’s characterization as a “distribution.”

Rule 101 -- Restrictions on the Activities of Distribution Participants and Their Affiliated Purchasers

Rule 101 governs the activities of persons participating in a distribution of securities, other than the issuer or selling security holder (*e.g.*, underwriters, prospective underwriters, and participating brokers and dealers), as well as their respective “affiliated purchasers.”¹⁹ Like Rule 102, Rule 101 prohibits persons subject to the rule from bidding for, purchasing,

or attempting to induce any other person to bid for or purchase, the subject security or any reference security during the applicable restricted period.

Restricted period. As with Rule 102, the restricted period(s) to which a distribution participant and its affiliated purchasers are subject depends upon the nature of the distribution, as well as the circumstances of the particular security and issuer involved. In a traditional distribution in connection with an underwritten offering, the commencement of the restricted period keys off of the pricing of the offering and, depending upon the security’s ADTV value and the issuer’s public float value, will begin one or five business days prior to the pricing of the offering, just as it does under Rule 102.²⁰

The restricted period for an underwriter continues until such time as the underwriter has distributed its allotment, and any stabilization arrangements and trading restrictions in connection with the distribution have been terminated.²¹ For other distribution participants (*e.g.*, a selling dealer), the restricted period will end when their allotment is fully allocated.²² Distribution participants who can claim Rule 101’s “actively-traded security” exception (discussed below) will not be subject to any Rule 101 restricted period for such security, even though the issuer and any selling security holders would remain subject to a restricted period under Rule 102.

Exempted securities. Like Rule 102, Rule 101 excepts the following categories of securities from the restrictions of the rule: (a) asset-backed securities, and non-convertible debt and preferred securities, that are in each case rated investment grade; (b) “exempted securities,” as defined in Section 3(a)(12) of the Exchange Act; and (c) face-amount certificates and

¹⁸ Details on the SEC’s historical interpretation of the “distribution” criteria, and suggestions as to certain limitations and controls that might serve to mitigate the risk of a “distribution” characterization, are discussed *infra*.

¹⁹ “Distribution participant” is defined in Rule 100 of Regulation M to include “an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution.” See *supra* note 6 for a discussion of “affiliated purchasers.”

²⁰ In those limited instances where a firm becomes a distribution participant, including as a prospective underwriter, only after the restricted period has otherwise commenced, the restricted period for that particular distribution participant will begin at such point as the firm becomes a “distribution participant.” This distinction is relevant only in very limited circumstances, such as when a firm is invited to participate in the syndicate at the ‘eleventh hour.’

²¹ An underwriter will not be deemed to have completed its participation in the distribution if a syndicate overallotment option is exercised in an amount in excess of the net syndicate short position at the time of such exercise. See the definition of “completion of participation in a distribution” in Rule 100.

²² See the definition of “completion of participation in a distribution” in Rule 100. As under Rule 102, the restricted period for other types of distributions may be calculated somewhat differently. See *supra* note 12.

redeemable securities issued by an open-end management investment company or unit investment trust.²³ Rule 101, however, also includes an exception for so-called “actively-traded securities” – *i.e.*, securities with an ADTV value of at least \$1 million that are issued by an issuer whose common equity securities have a public float value of at least \$150 million, provided the securities are not issued by the distribution participant or any affiliate of the distribution participant.²⁴ The actively-traded security exception is one of the most valuable and widely relied upon exceptions to Rule 101. Persons subject to Rule 101 may engage in activities with respect to excepted securities without regard to the restrictions and limitations otherwise contained in the rule.

Excepted activities. Although many of the provisions of Rule 101 are substantially analogous to those of Rule 102, Rule 101 contains certain additional exceptions intended to recognize distribution participants’ significant role in the marketplace and their perceived lesser interest in manipulating an offering. Similar to Rule 102, Rule 101 includes exceptions for certain odd-lot transactions, exercises of securities, unsolicited transactions, and transactions in Rule 144A-eligible securities. However, Rule 101(b) also contains exceptions for the publication or dissemination of research in compliance with Rules 138 or 139 under the Securities Act, certain basket and *de minimis* transactions, Nasdaq passive-market making in compliance with Rule 103, and stabilizing transactions in compliance with Rule 104.

ATM program implications. As previously noted, many securities firms elect to mitigate their own Regulation M exposure in connection with ATM program sales by simply confining their participation in these programs to issuers that satisfy the “actively-traded security” criteria. In volatile markets, where trading volume and stock prices can shift significantly over relatively brief periods of time, these firms can nevertheless find themselves with clients that cease to satisfy the criteria mid-program. Moreover, some of the issuers most interested in raising capital under an ATM program may be those that have never, or at least no longer, satisfy the criteria. As securities firms continue to search for business and issuers shop their options,

some firms that previously confined these engagements to actively traded issuers are revisiting that policy.

Given their role in the market place, the implications of being subject to an extended Regulation M restricted period could be particularly severe for distribution participants. Suffice to say that if a firm accepts an ATM program engagement for a non-actively traded issuer, both the issuer and the distribution participant should be aligned in their desire to avoid the program’s characterization as a “distribution.” By contrast, this may not necessarily be the case where the sales agent is able to claim the actively-traded security exception to Rule 101. In those instances, the sales agent may be less interested in constraining the nature and/or volume of its sales activity under the program.

Details on the SEC’s historical interpretation of the “distribution” criteria, and suggestions as to certain limitations and controls that might serve to mitigate the risk of a “distribution” characterization, are discussed *infra*.

Rule 103 -- NASDAQ Passive Market Making

Rule 103 permits a distribution participant, or one of its affiliated purchasers, that is a registered Nasdaq market maker in a subject or reference security to engage in passive market-making transactions in such security on Nasdaq during the Rule 101 restricted period, when such market making would otherwise be prohibited. The purpose of the rule is to minimize liquidity problems that might otherwise exist during the distribution of a Nasdaq security if the distribution participants or their affiliates who are Nasdaq market makers in the security were required to withdraw as market makers during the restricted period. Rule 103 is nothing more than an exception to the general prohibitions of Rule 101 of Regulation M. Unlike Rule 104, discussed *infra*, Rule 103 is not a “stand-alone” rule, and has no application independent of Rule 101. Notably, the exception afforded by Rule 103 is not available in any at-the-market²⁵ or best-efforts offering, nor is the exception available during any time in which a stabilizing bid is in effect.²⁶

²³ Rule 101(c)(2)-(4).

²⁴ Rule 101(c)(1). Note that this exception is broader than the exception for “actively-traded reference securities” contained in Rule 102(d). The exception in Rule 101 is available for the subject security, as well as any reference securities, provided the specified criteria and conditions are satisfied.

²⁵ Rule 100 defines an “at-the-market offering” as “an offering of securities at other than a fixed price.”

²⁶ When the exception is available, the rule imposes limits on the price and daily volume of the passive market maker’s bids and purchases, as well as on the market maker’s displayed bid size. It also requires the passive market maker to notify the Financial Industry Regulatory Authority, Inc. (FINRA) in advance of its intention to engage in passive market making, and the prospectus for any registered offering in which passive market-

ATM program implications. Although Rule 103 will only be implicated if the ATM program offering is deemed to involve a “distribution” subject to Rule 101 of Regulation M, the rule affords no relief for those ATM programs that *are* distributions -- because the rule expressly prohibits Nasdaq passive market making in “at-the-market offerings.”

Rule 104 -- Stabilizing and Certain Aftermarket Syndicate Activities

Rule 104 governs stabilizing and certain aftermarket syndicate activities in connection with an offering of securities and requires that all persons engaged in these activities follow the conditions of the rule. Although activity in compliance with the rule’s conditions is an excepted activity under Rule 101, the rule also applies to offerings that may not be subject to Rules 101 or 102 of Regulation M (e.g., the rule applies to offerings that do not implicate the “magnitude” and “special selling efforts and selling methods” elements of a “distribution,” as defined in Regulation M).

Stabilizing is defined in Rule 100 as “the placing of any bid, or the effecting of any purchase, for the purpose of pegging, fixing, or maintaining the price of a security.” Rule 104 prohibits all stabilizing in at-the-market offerings, and limits stabilizing bids and purchases in other offerings to those necessary to prevent or retard a decline in the market price of a security. The substantive conditions of the rule require that priority be given to independent bids at the same price, irrespective of the size of such bid at the time that it is entered. The rule also provides that no sole distributor or syndicate or group may maintain more than one stabilizing bid in any one market at the same price at the same time. Rule 104 imposes detailed conditions upon the price and manner in which stabilizing bids and purchases may be initiated, maintained, or adjusted; the maximum price at which stabilizing is ever permitted under the rule is the offering price of the security. The rule includes exceptions for “exempted securities” and transactions in Rule 144A-eligible securities, comparable to the exceptions contained in Rules 101 and 102, but notably lacks any exception for “actively-traded” securities.

ATM program implications. Because the rule prohibits stabilization in at-the-market offerings, the ATM program sales agent(s) must take care to refrain

from engaging in any stabilization activities, even if the security is “actively-traded.”

Rule 105 -- Short Selling in Connection with a Public Offering

While Rules 101 through 104 of Regulation M generally govern the activities of the parties involved in offering and selling the securities, Rule 105 governs an investor’s right to receive an allocation of public offering shares. Rule 105 of Regulation M only applies to an offering that is: (i) for equity securities; (ii) conducted on a “firm commitment” basis; and (iii) either an SEC-registered offering for cash, or a Regulation A or E offering for cash.²⁷ Offerings that meet each of these criteria are subject to the rule whether or not they rise to the level of constituting a “distribution.” The rule generally prohibits a person from purchasing shares in a covered offering if the person effected any “short sales” of the subject security during the Rule 105 restricted period, subject to certain limited exceptions. The Rule 105 restricted period is different than that applicable to Rules 101 and 102. Specifically, the Rule 105 restricted period commences upon the *later of* five business days prior to the pricing of the offering or, where applicable, the initial filing of the registration statement or a notification on Forms 1-A or 1-E. In either case, the Rule 105 restricted period ends at the time of pricing.

ATM program implications. While ATM programs are SEC-registered offerings, typically of equity securities for cash, they are by their nature conducted on a best-efforts (rather than a firm-commitment) basis. As such, Rule 105 should not apply to an ATM program in the first instance. This is beneficial because the inherent ongoing and real-time intra-day pricing of sales pursuant to an ATM program could render it cumbersome to ensure compliance with the rule, if its provisions were applicable.²⁸ It is worth noting, however, that the SEC previously solicited comment on the rule’s potential application to “best-efforts” offerings and has

²⁷ See Rule 105(a), (c).

²⁸ For example, a new Rule 105 restricted period would be established each time a new pricing occurred. Because a new pricing would occur each time a sale was effected, an institution purchasing from a broker-dealer participating in the offering would have to be able to know that, as of the moment of its purchase, it either (i) had not effected any short sales within the relevant Rule 105 restricted period (including in the hours or minutes preceding its purchase) or (ii) was able to claim one of the rule’s limited exceptions. Determining compliance on this sort of “real-time,” intra-day basis could prove difficult for at least some institutions with multiple trading desks and strategies.

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making transactions may be effected must disclose the information required under Items 502 and 508 of Regulation S-K, as applicable.

specifically reserved the possibility that it may in the future determine that best-efforts offerings should be subject to the rule's provisions.²⁹

What is a Distribution for Purposes of Rules 101 and 102?

A fundamental element to the application of Rules 101 and 102 is the presence of a "distribution" – *i.e.*, an "offering" of securities that is distinguished from ordinary trading transactions *both* by the magnitude of the offering and by the presence of "special selling efforts and selling methods." The definition is aimed at identifying those offerings that are "of such a nature or magnitude as to require restrictions upon purchases by participants in order to prevent manipulative practices."³⁰ The definition is *not* synonymous with the use of the term in the Securities Act. If either of the magnitude or special selling efforts/methods elements is missing, the offering is not a distribution and therefore Rules 101 and 102 will not apply.

In the case of a shelf registration, the SEC now takes the position that each individual takedown off the shelf must be individually examined to determine whether the elements of a distribution are present (*i.e.*, depending upon the magnitude of the particular takedown and whether special selling efforts and selling methods will be used).³¹

While the SEC staff has historically declined to opine on whether any particular proposed offering constitutes a "distribution" within the meaning of Regulation M, certain SEC releases and enforcement actions offer some guidance on how the two elements of a distribution should be analyzed.

SEC interpretive guidance. The "magnitude" element of the distribution definition is focused upon whether the amount of securities being sold is sufficiently large as to

give rise to an increased incentive to manipulate the market in an effort to facilitate the success of the offering. Magnitude is not measured in absolute terms but rather must be evaluated relative to the circumstances of the specific issuer and security. The SEC has stated that factors relevant to the magnitude element include "the number of shares to be registered for sale by the issuer, and the percentage of the outstanding shares, public float, and trading volume that those shares represent."³²

In 1982, the SEC proposed to codify the SEC staff's historical position that an offering made in compliance with *both* the then-applicable volume and manner of sale conditions of Securities Act Rule 144 would not be deemed a "distribution" for purposes of former Rule 10b-6.³³ Although the SEC ultimately chose not to adopt the safe harbor, its rationale for declining to do so was not premised upon any particular concern that such offerings might still give rise to heightened manipulation incentives. Rather, the SEC's decision was apparently influenced by a "significant number of comments that opposed inclusion of the safe harbor," in part based upon fears that the safe harbor would evolve into a prescriptive standard.³⁴

The "special selling efforts and selling methods" element of the distribution definition is generally intended to assess whether the nature of the compensation structure and sales efforts increase a distribution participant's incentive (or opportunity) to manipulate the market in order to facilitate the offering. The SEC has said that the "presence of special selling efforts and selling methods may be indicated in a number of ways, including the payment of compensation greater than that normally paid in connection with

²⁹ Rel. No. 34-56206 (2007). Of course, any SEC effort to change the scope of offerings subject to the rule would be subject to the notice and comment process.

³⁰ *Bruns, Nordeman & Co.*, 40 SEC 652, 660 (1961). The two elements of Regulation M's "distribution" definition, which is identical to the definition employed in former Rule 10b-6, have their origins in the *Bruns Nordeman* case (in explaining how to identify a "distribution," the SEC took the position that "a distribution is to be distinguished from ordinary trading transactions and other normal conduct of a securities business upon the basis of the magnitude of the offering and particularly upon the basis of the selling efforts and selling methods utilized.").

³¹ See Rel. No. 34-38067 (1996), at text accompanying n.46.

³² See Rel. No. 34-33924 (1994), at text accompanying n.44.

³³ See Rel. No. 34-18528 (1982). At that time, the volume limitations of Rule 144(e) required that sales by affiliates and sales by non-affiliates who had held securities for less than a period of three years should not exceed the greater of (i) one percent of the shares or other units of the class outstanding as shown in the issuer's most recent report or statement, (ii) the average weekly reported volume of trading in such securities on all national securities exchanges and/or reported through the automated quotation system of a registered securities association during the preceding four calendar weeks, or (iii) the average weekly volume of trading in such securities reported through the consolidated transaction reporting system during the preceding four calendar weeks.

³⁴ See Rel. No. 34-19565 (1983), at n.15 and accompanying text.

ordinary trading transactions.”³⁵ The SEC has also expressed the view that:

[i]n those situations where a broker-dealer sells shares on behalf of an issuer or selling security holder in ordinary trading transactions into an independent market (*i.e.*, without any special selling efforts) the offering will not be considered a distribution and the broker-dealer will not be subject to Rule 101. *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 its sales, even if the securities are sold in ordinary trading transactions.*³⁶

These interpretative statements seem to presuppose that a sales agent’s receipt of “unusual transaction-based compensation” is somehow synonymous with the firm’s use of special selling efforts and selling methods.³⁷ In other words, it appears to operate on the assumption that sales agents will have a greater incentive to use special selling efforts and selling methods if they are being paid “unusual” transaction-based compensation to place the shares. But the absence of unusual or extraordinary compensation may not necessarily serve to protect an offering from distribution characterization.

Of course, there is also the issue of whether compensation may be viewed as either unusual or extraordinary. Given the ultimate goal of identifying those offerings that present a heightened incentive to manipulate, the concept should presumably, like the magnitude element, be evaluated on a relative rather than absolute basis – *i.e.*, what may constitute “extraordinary” compensation for one firm may be comparatively more standard for another.

When the SEC in 1982 proposed a safe harbor from the distribution definition for offers and sales in compliance with the volume and manner of sale conditions of Rule 144, it emphasized that such sales would have to be effected in “brokerage transactions,” or in transactions directly with a market maker.³⁸ It also focused upon the fact that the seller would be “prohibited from either soliciting orders from prospective purchasers to buy the securities or making any special compensation arrangements in connection with the sale of such securities.”³⁹

In light of the SEC’s historical focus on compensation and solicitation, it seems reasonable to conclude that shares sold directly onto the floor of an exchange pursuant to a standard commission schedule generally would be less indicative of “special selling efforts and selling methods,” while solicitations of institutions and the receipt of extraordinary commissions for doing so would be more indicative of such efforts and methods.

Other indicia of special selling efforts and selling methods cited by the SEC include the conducting of “road shows” and the delivery of a sales document (*e.g.*, a prospectus or market letters).⁴⁰ It would seem self-evident that the mere fulfillment of the obligation to deliver a prospectus under the Securities Act cannot be dispositive with respect to the presence of special selling efforts and selling methods. If it were, then the special selling efforts/methods prong of the “distribution” definition would have no import in the context of a public offering, leaving the size of the offering as the sole determinant. Rather, the more relevant factor would appear to be the dissemination of a prospectus or other offering document to solicit purchasers’ buy orders. In apparent recognition of this distinction, at least one sales agency agreement for a recent ATM program included language stating that program sales pursuant to the agreement would be made only by means of ordinary brokerage transactions between market members that qualify for delivery of a prospectus to the market in accordance with Securities Act Rule 153.

Enforcement proceedings. An understanding of the two discrete prongs of the “distribution” definition is further aided by consideration of certain SEC opinions and enforcement proceedings.

For example, the SEC found that a “distribution” was present when the sole market maker in an OTC Bulletin Board stock sold over 120,000 shares of the stock over a

³⁵ Rel. No. 34-19565 (1983) at n.13.

³⁶ See Rel. No. 34-38067 (1996) at text accompanying n.48 (emphasis added). The staff further noted that an “independent market” means “one not dominated or controlled by the broker-dealer, and where the price is not manipulated by the broker-dealer or others acting in concert with the broker-dealer.” *Id.* at n.48.

³⁷ Seemingly in response to this SEC statement, some sales agency agreements seek to document the non-extraordinary nature of the sales commissions generally provided for under the agreement by stating that if the sales agent engages in any special selling efforts, it will be paid a different (presumably larger) commission by the issuer, which commission will be agreed upon at the time of sale.

³⁸ See Rel. No. 34-18528 (1982), at text accompanying nn.19-20.

³⁹ See Rel. No. 34-18528(1982), at text accompanying n.21.

⁴⁰ See Rel. No. 34-33924 (1994), at text accompanying n.46.

two-day period by mobilizing the firm's sales force to sell the stock to customers, promoting the stock to the sales force through meetings and individual conversations in which "extravagant representations [and] inherently fraudulent price predictions" were made, and promising the sales force "substantial compensation" for their efforts.⁴¹

In another case, the SEC concluded a market maker was engaged in a "distribution" when over a two-day period it purchased 1.3 million warrants from certain institutional investors and resold those same warrants to the firm's retail customers. Noting that the 1.3 million warrants purchased and sold represented more than 36% of the warrants issued and outstanding at that time, and more than 38% of the public float of the warrants, the SEC found that the "magnitude" element of a "distribution" was present.⁴² The SEC also focused upon the fact that other market makers' activity in the warrants during the same time period was insubstantial by comparison.⁴³ The presence of special selling efforts and selling methods was evidenced by, among other things, the firm's use of a "major sales campaign" to sell the warrants, with the sales force receiving almost three times the sales commission they would normally receive.⁴⁴

Where a significant amount of stock was sold over a handful of days, using a "nationwide sales campaign" involving "the dissemination of favorable information for use by [the firm's] sales force, sales quotas, a bifurcated compensation system, and a 'three-step cold call program,'" special selling efforts, and a distribution, were found to exist.⁴⁵

Likewise, a distribution was concluded to exist when a registered broker-dealer owning approximately 14% of an issuer's shares determined to decrease its position and sell the stock to over 100 of its customers. The special selling efforts identified included the preparation and delivery of a research report on the specific company (something the firm had not done before), as well as daily interoffice announcements alerting the sales force to the existence of the research report and the firm's sizeable position in the stock, and encouraging them to sell the stock.⁴⁶

Other sales of large amounts of stock involving the aggressive mobilization of a firm's sales force and the payment of larger than normal sales commissions have also been found to be indicative of a "distribution," especially when the selling broker-dealer is in a position of domination and control over the market for the security or is engaging in other activities intended to support the aftermarket (*e.g.*, via policies discouraging the acceptance of customer sell orders and/or rescinding salespersons' commissions where purchasers sell the stock within a specified period of time (*e.g.*, 90 days) after purchase).⁴⁷

By the same token, an SEC administrative law judge concluded that there was insufficient evidence of a "distribution" where the amount of stock sold, while sizeable, was not accompanied by extraordinary compensation or sales efforts, and there were several other market makers active in the stock.⁴⁸

CONCLUSIONS

It is clear that there is no one-size-fits-all approach to analyzing a particular offering's treatment as a "distribution" for purposes of Regulation M. The magnitude and special selling efforts/methods elements of the definition are inherently facts and circumstances intensive, and a determination as to their presence or absence in the context of a particular offering is best undertaken in discussion with knowledgeable counsel.

footnote continued from previous column...

because the firm "dominated and controlled the market" for the securities).

⁴⁶ *In the Matter of First Albany Corporation*, 50 SEC 890 (1992).

⁴⁷ *See, e.g., In the Matter of David M. Haber*, 52 SEC 201 (1995); *In the Matter of Collins Securities Corp.*, 46 SEC 20 (1975), *rev'd and remanded on other grounds*, 562 F.2d 820 (D.C. Cir. 1977); *In the Matter of Billings Associates, Inc.*, 43 SEC 641 (1967); *In the Matter of Theodore A. Landau*, 40 SEC 1119 (1962).

⁴⁸ *In the Matter of Oppenheimer & Co., Inc.*, 1979 SEC LEXIS 2444 (Jan. 3, 1979).

⁴¹ *In the Matter of John Montelbano*, Rel. No. 34-47227 (2003), at text accompanying nn.25 and 43.

⁴² *A.S. Goldmen*, Rel. No. 34-44328 (2001) at text accompanying n.37 (*citing Collins Sec. Corp.*, 46 SEC 20, 35 (1975) (offering constituting more than 30% of the outstanding stock satisfied the magnitude element of a distribution), *rev'd and remanded on other grounds*, 562 F.2d 820 (D.C. Cir. 1977)).

⁴³ *A.S. Goldmen*, Rel. No. 34-44328 (2001) (*citing Theodore A. Landau*, 40 SEC 1119, 1125 (1962) (broker-dealer can be engaged in a distribution even where the number of shares represents only a small percentage of the shares outstanding if there is no evidence of substantial activity by others)).

⁴⁴ *A.S. Goldmen*, Rel. No. 34-44328 (2001), at text accompanying nn.38-39 (further noting that the firm sold only slightly in excess of 180,000 shares of all others issuers during the same two-day period).

⁴⁵ *In the Matter of John J. Cox*, Rel. No. 34-33577 (1994) (further noting that there was no "independent market" in the securities

While most of the historical SEC guidance and regulatory proceedings are not directed at the specific circumstances of an ATM program, they do afford a framework of factors the presence or absence of which will undoubtedly affect the analysis of a particular program. To this end, and subject to the unique circumstances of the particular program, including the issuer and the participating sales agent(s), implementation of some or all of the following measures may serve to mitigate the relative risk of an ATM program's characterization as a "distribution" for purposes of Regulation M.

- Consider engaging more than one sales agent to effect sales under the program (but still use only one such agent on any given trading day). This might serve to lessen each individual firm's expectations as to how much stock it will be asked to sell and the commissions it will earn, thereby potentially decreasing its relative incentive to manipulate or to engage in special selling efforts and methods. (Based upon a review of prospectuses and sales agency agreements for a number of recent ATM offerings, it appears that the use of more than one sales agent is becoming an increasingly common practice.)
- Refrain from mobilizing the sales agent's sales force to sell the shares, whether by specific direction or by means of special incentives or compensation.
- Refrain from the use of any written offering materials, including the delivery of a prospectus, market letters, or research reports, to solicit buy orders in the stock.
- Confine sales efforts to those consistent with the "manner of sale" conditions of Securities Act Rule 144.
- Limit commissions payable to an ATM program sales agent to those commensurate with the agent's standard commission schedule for other ordinary trading transactions; likewise, limit commissions paid to the firm's registered persons effecting the program sales so that they are no greater than those paid for other ordinary trading transactions.

- If it is contemplated that special selling efforts and/or selling methods may be utilized for certain select program sales, ensure that the circumstances are contractually provided for – e.g., identifying how the parties will determine whether and when such efforts or methods will be utilized and what alternative contractual terms and commission schedule will apply to such sales.
- Ensure that there are active market makers in the stock (other than the sales agent effecting the program sales) and that they continue to represent more than a nominal amount of daily trading activity in the stock.
- Impose daily and/or weekly limitations on the amount of program sales (e.g., restricting the amount of stock sold to a relatively small percentage of the security's trailing ADTV and/or the issuer's public float).
- Consider periodically suspending program sales activity for a series of trading days (e.g., one week "on," one week "off").

The issuer and its sales agent(s) should confer with one another, and their respective counsel, with a view to arriving at a consensus regarding the ATM program's treatment for purposes of Regulation M (e.g., to ensure that a sales agent is not identifying the offering as a "distribution" subject to Regulation M, while the issuer is simultaneously taking the position that the offering is *not* a distribution for purposes of Regulation M).⁴⁹ Finally, the issuer and the sales agent(s) should take care to avoid any stabilization activity in violation of Rule 104 of Regulation M. ■

The views expressed in this article are exclusively those of the authors and do not necessarily reflect those of Sidley Austin LLP or its clients. This article has been prepared for informational purposes only and does not constitute legal advice.

⁴⁹ Certain U.S. self-regulatory organizations have rules requiring their member firms to provide notification of their participation in a "distribution" of securities subject to Regulation M. See, e.g., FINRA Rule 5190.

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