February 13, 2007

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Release No. 34-54888; File Number S7-20-06
Short Selling in Connection With a Public Offering

Ms. Morris:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (the "SEC" or "Commission") proposed amendments to Rule 105 of Regulation M ("Rule 105" or the "Rule").[2] The proposed amendments would, in essence, prohibit any person from purchasing an SEC-registered offering of securities for cash if such person effected short sales in the offered security during the "Restricted Period" immediately prior to pricing of the offering. The Commission also raised in the Rule 105 Proposing Release ("Proposing Release") a number of other questions concerning the operation of the Rule. It is our understanding that the Commission does not intend to adopt new modifications to Rule 105 regarding the issues raised in these questions at this time, but would propose their adoption in a separate rulemaking proceeding. SIFMA appreciates the opportunity to comment further on any such specific proposals at the appropriate time. SIFMA has, however, provided herein some initial responses to such questions.

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] Securities Exchange Act Release No. 54888 (December 6, 2006), 71 FR 75002 (December 13, 2006) ("Proposing Release").

I. Introduction and Executive Summary

In its current form, Rule 105 is generally designed to prevent market participants from selling short in advance of a public offering of securities for cash and then covering such short sales with securities purchased in the offering, an activity that the Commission believes can "artificially depress market prices which can lead to lower than anticipated offering prices, thus causing an issuer's offering proceeds to be reduced."[3] Specifically, the Rule currently prohibits any person from covering a short sale with securities obtained from an underwriter or broker-dealer participating in a public offering for cash if the short sale was effected within a "Restricted Period" immediately prior to the pricing of the offering. Under the current Rule, the Restricted Period begins on the later of: (i) the five business days prior to the pricing of the offering; or (ii) the initial filing of the registration statement or notification on Form 1-A. In each case the Restricted Period continues until the pricing of the offering. Rule 105 presently only applies to SEC-registered offerings of securities for cash, and does not apply to Rule 144A or Regulation S offerings. In addition, offerings that are conducted other than on a firm commitment basis (*e.g.*, best efforts and contingency offerings) are expressly excepted from the current Rule.

The SEC has proposed to amend Rule 105 to state as follows:

> "In connection with an offering of securities for cash pursuant to a registration statement or a notification on Form 1-A (Section 239.90 of this chapter) filed under the Securities Act of 1933, it shall be unlawful for any person to effect a short sale (as defined in Section 242.200) and then purchase, including enter into a contract of sale for, the security in the offering if that person effected such short sale in the offered security during the shorter of: (i) the period beginning five business days before the pricing of the offered securities and ending with such pricing; or (2) the period beginning with the initial filing of such registration statement or notification on Form 1-A and ending with the pricing."

The main difference between the Rule as proposed, and its current form, is that the proposed version would expressly *prohibit* any person from purchasing in an offering if such person effected short sales during the Restricted Period immediately prior to pricing, whereas the current rule does not impose such a general prohibition, but rather only prohibits using the securities received in the offering to "cover" such Restricted Period short sales.

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[3] *Id.*, 71 FR at 75002.

SIFMA understands that the Commission's objective is to establish a bright-line test that will "promote investor and issuer confidence in pricing integrity and in the offering process, which should facilitate capital formation."[4] Notwithstanding the Commission's stated purpose, SIFMA believes that the proposal, as drafted, could result in unintended negative consequences, including the creation of new hurdles that hinder the efficiency of the capital formation process -- to the ultimate detriment of the issuers the Rule is seeking to protect. SIFMA is particularly concerned about the impact of the proposed amendments in situations where investors effect short sales during the Restricted Period without any knowledge that the offering is going to occur. Moreover, by effectively precluding a certain group of investors from receiving an allocation, the proposed changes could negatively affect pricing efficiency and could impact underwriters' decisions on whether to commit to some offerings. In this way, the proposals may in practice run contrary to the purpose of the Securities Offering Reform rules adopted in 2005 of providing improved market access, especially to "well-known seasoned issuers."

SIFMA addresses these concerns below, and offers several suggested alternatives that it believes would foster the policy goals of the proposed amendments, while ameliorating the potential adverse consequences. Specifically, SIFMA recommends that the Commission adjust the rule as follows:

- Define the Rule's Restricted Period so that it would not begin earlier than the point of public announcement of the offering.
- Better align the Rule 105 Restricted Period with Rule 101 of Regulation M, including incorporating an "actively-traded security" exception to Rule 105.
- Incorporate into the Rule a concept of "aggregation units" or separately identifiable divisions or units within an entity, so that short sales effected by one such unit within the legal entity would not prohibit the entire entity from participating in the offering.
- Include an exception from the Rule for certain types of short sales which do not raise the policy concerns the Rule is designed to address.
- Include an exception to allow a person to "cure" a potential violation of the Rule by purchasing, prior to pricing, to cover short sales effected during the Restricted Period.
- Replace the term "offering securities" in the Rule with "subject securities" or otherwise define the term "offering securities" in a manner consistent with Regulation M's definition of "subject securities."
- Address the elimination of the provision that the offering be "purchased from an underwriter or broker-dealer participating in the offering" by including an exception from the prohibitions of the Rule for purchases by

[4] *Id.*

an underwriter or other broker-dealer acting as a distribution participant in connection with the offering.

- Exclude offerings of debt securities from the Rule.

SIFMA respectfully urges the Commission to consider these alternatives, and solicit further public comment through another proposing release, rather than proceeding straight to adoption.

Additionally, SIFMA also addresses certain questions raised by the Commission in the Proposing Release, and responds to certain statements regarding alleged current "violations" of the Rule. As detailed below, SIFMA:

- Does not believe that underwriters should be required to obtain a certification that the investor has not effected short sales during the Restricted Period because such a requirement would not be practicable, would impose significant delays in the allocation process, and would improperly suggest underwriter liability for the actions of investors.
- Supports the current exception for offerings conducted on a best efforts basis.
- Believes that Rule 105 should not be extended to cover so-called "PIPE transactions," and that the Commission's concerns are properly addressed by existing general anti-fraud and anti-manipulation rules.
- Believes that expansion of Rule 105 to "long" sales effected during the Restricted Period is unnecessary.

SIFMA also is concerned that the Commission may be using the Proposing Release to set forth new interpretive guidance which we believe is inconsistent with the language of the current Rule, as well as existing interpretations. In that regard, SIFMA requests the Commission clarify certain statements made in the Proposing Release relating to alleged violations of the current Rule.

SIFMA's comments, recommendations and responses to questions are provided in greater detail below.

II. Potential Negative Consequences of Proposed Amendments

SIFMA believes that the Commission's proposed amendments to Rule 105 could negatively impact the ability of broker-dealers to place securities sold by issuers or selling shareholders, particularly in an "overnight" or "bought" deal, or any similar situation where potential investors are generally unaware that an offering is going to occur. Specifically, the "bright-line" test outlined in the proposed amendment would prohibit any potential investor from participating in such an offering if such person had effected any short sales in the offered security during the Rule's Restricted Period. This would even be the case where, at the time such person effected such short sales, they had

no knowledge that the subject offering was going to occur. This has been a significant issue since the Commission's prior elimination of the Rule's shelf offering exception, and the current proposal to reformulate the Rule into a strict allocation prohibition only further exacerbates the point.

As previously noted, the Rule's Restricted Period is calculated by reference to the pricing of the offering – a point in time that is controlled by the issuer and the underwriters – not the potential investors. As such, even in the case of an offering announced well in advance of the ultimate pricing date, potential investors are not in a position to predict with certainty the date and time when pricing will occur (and therefore are not in a position to accurately and assuredly identify the point at which the Rule's Restricted Period will begin). Institutional investors are in many cases large, complex organizations and often times comprised of multiple business units or departments that are, in turn, responsible for managing different aspects of the organization's overall balance sheet and risk-exposure. Imposing an outright prohibition against receiving an allocation of offering shares in every instance where the investor (or some unit or division thereof) sold short the offered security within the Rule's Restricted Period – a time period ultimately controlled by the issuer and the underwriters, rather than the institutional investors – could, unto itself, significantly impair the success of an issuer's or shareholder's public offering of securities by effectively limiting the universe of eligible investors for such offering. The SEC's goal of creating greater pricing efficiency for issuers would be frustrated by such a limitation. Imposing such a restriction arguably also appears to favor investors that do not engage in short selling or that engage in such activities only on a limited basis over larger, more complex organizations that have one or more units or departments regularly engaged in short selling activity.

These negative consequences are further exacerbated when the investors have no knowledge, at the time they are selling short, that an offering is about to occur. Without knowledge of the imminent offering, their short sales necessarily cannot be motivated by the expectation of receiving an allocation and thereby being able to capture the "spread" between the present market price and the anticipated offering price, nor would they be able to consciously refrain from short selling in order to preserve their eligibility to receive an allocation. In short, SIFMA believes that this amendment to the Rule could especially impact institutional investors (including mutual funds), a major source of investing in public offerings, including overnight deals.

SIFMA also presumes, and requests that the SEC expressly confirm, that the Rule's reference to "person" is confined to the natural person or legal entity for whose account the short sale was effected, consistent with the definition of "person" in Section 3(a)(9) of the Exchange Act.[5] Applying a more expansive construction of the

[5] Section 3(a)(9) defines the term "person" to mean "a natural person, company, government, or political subdivision, agency, or instrumentality of a government."

term, in the context of the Rule's prohibitions, would have a significant impact on the capital formation process. For example, the proposed amendments should not prohibit a mutual fund from being able to receive an allocation in an offering if another mutual fund within the same fund complex effects short sales during the Restricted Period.

Even in the case of a single legal entity that effected short sales during the Restricted Period, SIFMA believes there are instances in which prohibiting the entire entity from receiving an allocation merely because a particular business unit or division within that entity effected short sales during the Restricted Period would create an unduly harsh result that could potentially be more harmful than helpful to issuers. For example, SIFMA believes such a result would be inappropriate where the short sales were not effected with any knowledge of the offering and/or with any intent to capture an arbitrage between the market price and the offering price (*e.g.*, short sales effected as part of, among other things, initial and dynamic hedging strategies, long/short strategies, or bona-fide market making activities could equally prohibit participation in an offering).

As institutional investors are often a major source of investing in deals, especially overnight deals, the proposed Rule's bright-line test could therefore severely impact the ability for issuers and selling shareholders to sell their securities in the market. This would be in contravention of the Commission's stated goal of "facilitating capital formation."

III. Potential Ways to Resolve These Unintended Consequences

A. Amend the Restricted Period Definition to Incorporate Public Announcement of Offering

SIFMA recommends that the Commission consider amending the definition of the Rule's Restricted Period to incorporate a concept of public announcement of the offering in question – such that the Rule's Restricted Period would not begin earlier than the point of the public announcement of the deal. Such an approach would be consistent with the policy purpose behind the Rule, which seeks to address the activity of a person "selling the security short with the knowledge that they are very likely to be able to cover their short positions with offering shares that they are allocated."[6] Short sales effected prior to public announcement of the deal could not be based on an intent to capture such "offer price discount." Indeed, the Commission stated in the Proposing Release that "Rule 105 does not ban short sales because certain short sales may be motivated by a short seller's evaluation of a security's future performance and contribute to pricing efficiency and price discovery."[7] Short sales effected prior to

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6 Proposing Release, 71 FR at 75003.

7 *Id.*

public announcement of the offering could not be for the purpose of capturing an "offering price discount" and thus should not taint the ability for such person to purchase in the offering.

Such an approach would appear to be consistent with how Regulation M calculates the point of commencement of the restricted period for underwriters and other distribution participants subject to Rule 101 of Regulation M. In particular, the restricted period under Rule 101 does not commence for an underwriter until the *later of* 1 or 5 business days prior to the pricing of the offering *or such time as the underwriter becomes a distribution participant.* In this way, the rule accommodates situations in which an underwriter is invited into a deal late (*i.e.*, after the restricted period for the offering has otherwise commenced) and where such underwriter may have been bidding for or purchasing the subject security in the day or days prior to becoming a "prospective underwriter."[8] For example, in the case of a distribution involving a "5 day" stock, and where a broker-dealer becomes a "prospective underwriter" only 3 business days prior to pricing, any bids or purchases by that broker-dealer in the 2 business days prior to becoming a prospective underwriter would not constitute a violation of Rule 101, or necessitate that the pricing of the deal be delayed by 2 business days.

Such a concept of restrictions commencing upon "announcement" of an offering has likewise been set forth in other rules, including Exchange Act Rule 14e-4, which requires a person to consider, in calculating their net position for purposes of tendering into a partial tender offer, any in-the-money call options written after the offer "is first publicly announced or otherwise made known by the bidder to holders of the security to be acquired."

B. Better Align the Rule 105 Restricted Period with Rule 101

SIFMA also believes that the Commission should consider amending the Rule 105 Restricted Period (for preventing a short seller from getting an allocation of the offering shares) so that it would begin no earlier than the commencement of the restricted period to which underwriters are subject under Rule 101. In accordance with Rule 101, this would include, among other things, the incorporation of an "actively-traded security" exception to Rule 105.[9] The "actively-traded security" exception to Rule 101 of

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[8] Rule 100 of Regulation M defines a "prospective underwriter" as a person who: (i) "has submitted a bid to the issuer or selling security holder, and who knows or is reasonably certain that such bid will be accepted, whether or not the terms and conditions of the underwriting have been agreed upon;" or (ii) "has reached, or is reasonably certain to reach, an understanding with the issuer or selling security holder, or managing underwriter that such person will become an underwriter, whether or not the terms and conditions of the underwriting have been agreed upon."

[9] Pursuant to Rule 101(c)(1) of Regulation M, "actively-traded securities" are defined as "securities that have an ADTV value of at least $1 million and are issued by an issuer whose common equity securities have a public float value of at least $150 million; provided, however, that such securities are not issued by the distribution participant or an affiliate of the distribution participant."

Regulation M is premised on the theory that such highly-liquid securities are less susceptible to manipulation and, therefore, the Commission is willing to forego the restrictions of Rule 101, and leave any manipulation concerns to be addressed by the general anti-manipulation provisions.[10] SIFMA believes that, to the extent that Rule 101 of Regulation M allows distribution participants to be bidding for, purchasing, and inducing others to bid for or purchase, the subject security through the pricing period (*i.e.*, because the security qualifies as an "actively-traded security"), then investors should equally be able to receive allocations of such securities even if they sold short in the day or days prior to pricing. In other words, with respect to actively-traded securities, there is less potential for manipulation, both on the short and long side.

For similar reasons, we believe that the Commission should otherwise better align the Rule's Restricted Period with the restricted period to which the issuer, selling security holders, distribution participants and their respective affiliated purchasers are subject under Regulation M. Even for securities that do not qualify as "actively-traded securities," the commencement of the Rule's Restricted Period should further depend upon the average daily trading volume value of the security, as well as the public float value of the issuer, comparable to the way the restricted period is determined for purposes of Rules 101 and 102. This would mean that, with respect to many equity offerings, the Rule's Restricted Period would begin only 1 business day prior to pricing, which would thereby serve to minimize the universe of investors that may be ineligible to receive an allocation of the offering shares.

C. Incorporate Aggregation Unit Concept in Rule 105

In an effort to further mitigate the unintended consequences, SIFMA also recommends that the Commission recognize and incorporate a concept of "aggregation units," or recognition of separately identifiable divisions, departments or units within an organization, such that a potential investor (including a mutual fund or hedge fund) which had effected short sales during the Restricted Period (under the suggested revised definition of such term set forth above) would still be allowed to participate in the offering, so long as such investor does not allocate offering shares to the unit(s), department(s) or division(s) that effected such short sales during the Restricted Period. The SEC has shown a willingness to recognize these concepts in other contexts where a failure to do so would appear to have unintended and negative consequences. For

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[10] As the Commission stated in the Regulation M adopting release "the Commission continues to believe that an exclusion for actively-traded securities is appropriate. The costs of manipulating such securities generally are high. In addition, because actively-traded securities are widely followed by the investment community, aberrations in price are more likely to be discovered and quickly corrected. Moreover, actively-traded securities are generally traded on exchanges or other organized markets with high levels of transparency and surveillance." Securities Exchange Act Release No. 38067 (December 20, 1996), 62 FR 520, 527 (January 3, 1997) ("Regulation M Adopting Release") (further noting that securities meeting the specified criteria "have a sufficient market presence to make them less likely to be manipulated").

example, Regulation M, in its definition of "affiliated purchaser," recognizes the concept of separately identifiable departments or divisions within a single legal entity and we understand that the SEC staff has similarly interpreted Rule 14e-5(b)(8) to recognize the concept of separately identifiable departments or divisions within a legal entity. Likewise, Regulation SHO recognizes the concept of "aggregation units" within a registered broker-dealer, which SIFMA believes should also be recognized for purposes of Rule 105 (*i.e.*, so that short sales effected by one aggregation unit within a broker-dealer should not prohibit another aggregation unit within the broker-dealer from being able to participate in an offering).[11]

With respect to investors who are not registered broker-dealers, SIFMA is not suggesting that the Commission should, for purposes of Rule 105, adopt in a whole-sale fashion the conditions of the Regulation SHO aggregation unit exception, or one of the provisions utilized in other Commission rules. Rather, the provision should be carefully tailored to address the policy concerns at which Rule 105 is directed but without creating the detrimental effects discussed herein. SIFMA understands that other commenters, in particular the Investment Company Institute and the Managed Fund Association, intend to address these concepts and specific concerns in greater detail.

This approach could likely be most useful in the situation where shorting by one division or unit prior to announcement of, and without knowledge of, the deal would not prohibit another division or unit from being able to participate in the offering. Nevertheless, we believe such concept should equally apply after announcement of an offering, so that any short sales by one division or unit within an institutional investor, including by one strategy within a multi-strategy hedge fund (*e.g.*, in connection with delta hedging, index arbitrage, black box trading strategies etc.), would not preclude the entire legal entity from being able to participate in the offering.

D. Exceptions for Certain Types of Short Sales

In addition to the above recommendations, SIFMA recommends that the Commission also provide exceptions from the proposed general prohibition on purchasing in an offering, to the extent that short sales effected during the Restricted Period were effected for certain defined purposes and not for the purpose of capturing a spread between the security's current market price and a lower offering price. These could include short sales effected in connection with: (i) convertible arbitrage;[12] (ii)

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[11] Pursuant to Rule 200(f) of Regulation SHO, independent trading unit aggregation is available if: "(1) the broker or dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity; (2) each aggregation unit within the firm determines, at the time of each sale, its net position for every security that it trades; (3) all traders in an aggregation unit pursue only the particular trading objective(s) or strategy(s) of that aggregation unit and do not coordinate that strategy with any other aggregation unit; and (4) individual traders are assigned to only one aggregation unit at any time."

[12] *See* Section IV, *infra*, for a discussion of what is meant by "convertible arbitrage."

merger arbitrage; (iii) volatility trading; (iv) long/short strategies; (v) other hedging strategies; and (vi) bona-fide market making and customer facilitation activities. Should the Commission accept such an approach, SIFMA would urge the Commission to also be receptive to addressing, through exemptive relief, current or future strategies which may not fall under an enumerated exception but which also do not implicate the Rule's policy concerns.

E. Exception to Allow Person to "Cure" Potential 105 Violation

In addition to the recommendations outlined above, the Commission should also consider providing an exception to allow a potential investor to close-out (prior to pricing) any short sales effected during the Restricted Period, so that the investor may be able to participate in the offering. Such an approach would again serve to protect against the potential unintended negative consequences of the rule. Moreover, from a policy point of view, it could be argued that the investor's pre-pricing purchase of securities to cover such prior short sales would serve to offset any potential downward price impact associated with the prior short sales effected during the Restricted Period.

SIFMA notes that the Proposing Release raises a specific question on this point, namely inquiring whether a person should be required to close out their "entire short position" in the offering security, or only the amount of the short sales that such person effected during the Restricted Period.[13] In this regard, we believe that the requirement should be to cover only the amount of the short sales effected during the Restricted Period. Short sales effected outside the Restricted Period would not themselves trigger the Rule's prohibitions and therefore equally should not be required to be closed-out and covered in advance of pricing in order to "cure" or "refresh" the investor's eligibility to receive an allocation. Moreover, requiring a person to cover a short position in excess of that established during the Restricted Period could potentially result in the offering price being artificially "bid up," a result that should be of equal concern to the Commission.

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[13] The question from the Proposing Release had stated as follows: "Should the proposed rule provide an exception to allow a person who effects a restricted period short sale to purchase, including enter into a contract of sale for, the security in the offering if, after effecting the restricted period short sale but before pricing of the offering, the person closes-out the entire short position in an offered security with an open market purchase during regular trading hours that is reflected on the consolidated tape or other reporting media? Please discuss any alternatives, including whether the rule should provide an exception to allow a person who effects a restricted period short sale to purchase, including enter into a contract of sale for, the security in the offering if, after effecting the restricted period short sale but before pricing of the offering, the person can demonstrate, using required books and records, that the person closed-out the restricted period short sales (but not necessarily the person's entire short position) with an open market purchase during regular trading hours that is reflected on the consolidated tape or other reporting media…" Proposing Release, 71 FR at 75006.

IV. Meaning of Term "Offering Securities"/Scope of Offerings Covered

SIFMA notes that the Rule currently does not define the term "offering securities," and believes that the Commission should attach a definition to the term at this time. In particular, SIFMA recommends that the term should be defined consistent with Regulation M's concept of "subject security" and that the Rule's allocation prohibitions should not apply to persons who effected short sales in any "reference securities," as that term is defined in Regulation M. While this approach would be somewhat different from that applied under Rules 101 and 102 of Regulation M, we nevertheless believe that the distinction is critical to ensuring the continued viability of registered offerings of convertible securities (including convertible bonds) and other derivative securities – an important means by which issuers and selling security holders have historically accessed the capital markets.

If the Rule's allocation prohibitions were to apply equally to an investor who sold short the underlying common stock during the Rule's Restricted Period prior to the pricing of a convertible offering, many of the current investors in these types of offerings would be prohibited from receiving an allocation.[14] Specifically, such an application of the Rule would eliminate the current practice of investors in a convertible securities offering selling short the underlying common stock as part of hedging activity. Issuers and selling security holders engaged in registered convertible bond (or other derivative) offerings are generally well aware of such short selling by the investors and, in fact, benefit from such activity.

For example, investors engaging in convertible arbitrage strategies may realize profits by: (i) purchasing convertible securities; mandatory convertible securities, warrants or other securities with optionality; (ii) shorting a number of shares equal to the initial hedge required for the convertible securities, as determined by the convertible arbitrage investor; and (iii) purchasing and shorting shares as part of dynamic hedging of the position, which in effect enables the investor to realize gains or losses as a function of the underlying stock's volatility. When convertible arbitrage investors purchase a convertible security in a marketed registered offering, they will frequently short to establish their initial hedge after announcement and prior to pricing. The average price at which the investor establishes this initial short hedge serves as the stock price input for a Black/Scholes calculation by the investor, thus determining what price they are willing to pay for the convertible security. If convertible arbitrage investors are unable to short to establish their initial hedge prior to purchasing a marketed convertible, the issuer may in fact be disadvantaged in pricing the convertible offering because the convertible arbitrage

[14] This could even be the case if the short sales were effected as part of a hedging strategy in connection with a separate convertible bond offering than the one at issue.

investors may not be willing to pay as much due to the uncertainty as to the level at which they will be able to execute their initial hedge.

Moreover, if the prospective investors in such offerings are unable to effect short sales of the underlying during the Restricted Period, their appetite for purchasing registered convertible bond offerings could be significantly reduced. In short, such an application of the Rule could have a significant negative impact on issuers' ability to raise capital through registered convertible bond offerings.

V. Obtaining Certifications From Buyers Receiving Allocations

The Commission had raised a question in the Proposing Release as to whether potential investors in an offering should be required to "give an underwriter a certification that they have not effected and will not effect a short sale during the Rule 105 restricted period," and had also requested comment on "the costs and benefits of such a requirement for investors and underwriters."[15] SIFMA strongly opposes any requirement for underwriters to obtain such certifications from potential investors on a deal-by-deal basis. As a threshold matter, we note that the restrictions of the Rule apply to the persons who seek to purchase in the offering. Imposing a certification requirement on broker-dealers allocating the offering shares to investors could cast doubt on this point and suggest that underwriters are liable for the actions of investors.

Furthermore, obtaining signed certifications from prospective investors would not be practicable, and would impose significant delays in the allocation process. In this regard, it is worth emphasizing that Rule 105 is a very different situation from that of Rule 2790 of the National Association of Securities Dealers, Inc.'s ("NASD"). To begin with, Rule 2790 applies directly to the member firms. In contrast, and as previously noted, Rule 105 applies to the investors seeking to receive an allocation. Moreover, the Rule 2790 certification requirements are based upon a prospective investor's status and factors that are within that investor's control. The certification is obtained initially in writing and can thereafter be "refreshed" on an annual basis through negative consent. On the other hand, because the Rule 105 Restricted Period is determined by reference to the pricing of a specific offering, an investor would not be in a position to make the certification until after pricing occurred (*i.e.*, the point in time when the Restricted Period can first be calculated with certainty).

Most registered equity offerings are priced after the close of the market and the allocation process is typically completed shortly thereafter. If all goes well, the deal is declared "all sold" prior to the commencement of trading the next morning. Completing the allocation process quickly is critical to the underwriters' ability to complete the distribution and resume their normal market activity, free from the restrictions of Rule 101 of Regulation M. Prompt completion of the distribution is

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[15] Proposing Release, 71 FR at 75007.

equally important to issuers. Requiring that certifications be gathered from each investor would severely slow down the allocation process and therefore delay the completion of the distribution – a negative result for issuers, underwriters and investors alike. Therefore, SIFMA strongly recommends that the Commission not adopt a requirement for underwriters to obtain certifications from potential investors with respect to whether such investors effected short sales during the Restricted Period.

SIFMA would also request that the Commission provide further clarification as to the circumstances under which an underwriter might be deemed to have "aided and abetted" an investor's Rule 105 violation.[16] SIFMA members are themselves directly subject to a myriad of securities laws, rules and regulations. Other market participants, including issuers and investors, are also directly subject to various securities laws, rules and regulations. Those other parties are best postured to know their own obligations and ensure compliance therewith. While SIFMA recognizes that broker-dealers cannot turn a blind eye to illegal activities by their customers, broker-dealers should not be held responsible for policing their customers' compliance with their own legal requirements. Requiring the underwriters to affirmatively assess and verify investors' eligibility to receive an allocation would impose a significant new compliance burden and inevitably serve to delay the offering process, to the ultimate detriment of the issuer and the capital markets as a whole. Furthermore, imposing such an affirmative due diligence obligation would simply be impracticable in a number of situations, including where the potential investor's positions are held with another broker-dealer.

VI. Proposed Elimination of Provision re: Purchase From Underwriter or Broker-dealer Participating in Offering

SIFMA notes that the proposed revised language of the Rule has eliminated the provision in the current Rule that the offering securities be "purchased from an underwriter or broker-dealer participating in the offering," although the Commission has not provided in the Proposing Release any specific explanation for such amendment.

SIFMA is interested in understanding the Commission's reasons for the change and, in particular, requests clarification that, by making such change, the Commission did not intend to restrict an underwriter's or other broker-dealer's ability to participate as a distribution participant in the offering (and hence purchase the offering

[16] In this regard, we note that the Commission had made the following statement in the Proposing Release: "As with current Rule 105, responsibility for compliance with the proposal would rest with the person that effects a short sale during the restricted period and purchases, including enters into a contract of sale for, the security in the offering allocation. However, as with any securities law, rule or regulation, broker-dealers may be charged, depending on the facts and circumstances, for aiding and abetting or causing securities law violations by their customers." Proposing Release, 71 FR at 75005.

shares from the issuer, or a member of the underwriting syndicate, as part of the distribution process) merely because some unit within the firm had effected short sales during the Rule's Restricted Period. To make this point clear, SIFMA would recommend that the Commission provide an exception from the Rule's general prohibition for "any purchases by an underwriter or broker-dealer participating in the offering."

VII. Statements in Proposing Release Concerning Alleged Current "Violations"

SIFMA notes that, in various places throughout the Proposing Release, the Commission makes statements about alleged "violations" or "non-compliance" with the provisions of current Rule 105. SIFMA notes that, in some situations where the Commission is alleging "violations," the activity described actually does not run afoul of the Rule. Most troubling, the Proposing Release notes the following example of "activity meant to obfuscate the prohibited covering" of the current Rule, namely through "post-offering sales and purchases undertaken to give the appearance that the restricted period short sales were covered with shares other than the offering allocation":

> "For example, a person (1) effects a short sale of 5,000 shares during a Rule 105 restricted period, (2) purchases, including enters into a contract of sale for, 5,000 shares of the security in the offering, (3) following the purchase, or entry into the contract of sale, sells 5,000 shares and (4) contemporaneously or nearly contemporaneously purchases 5,000 shares. The Rule 105 violations may be complete when the restricted period short sale is covered with offering shares at step number 2 above. Once the restricted period short sale is executed and the person purchases, including enters into a contract of sale for, the offered securities, the position is economically flat. A contemporaneous or nearly contemporaneous post-offering purchase and sale does not undo the Rule 105 violation…"

SIFMA is concerned that, in the above statement, the Commission appears to be saying that under the current Rule, if a person has sold short during the Restricted Period and then purchases offering shares, such person would be in violation of current Rule 105 once he purchases the offering shares, in that such purchase would leave the person "economically flat," or at least decrease the amount of a person's net short position. Such an interpretation is completely inconsistent with the current version of the Rule, which prohibits the use of the offering shares to "cover" short sales effected during the Restricted Period – by establishing a "boxed" position, as per the above-stated description, such person has per-se not "covered" their open short position.

Furthermore, such statement is at direct odds with the Commission's 2004 Interpretive Release on Rule 105, which described certain "sham transactions," consisting of a sale of the offering shares and contemporaneous purchase of open market shares,

designed to evade compliance with the Rule. If the Commission had believed that a violation of Rule 105 occurs when a person effects Restricted Period short sale, and then purchases in an offering (thus making such person economically flat, or otherwise decreasing economic exposure on the short position), there would have been no reason for the Commission to issue the 2004 Interpretive Release. What is more, if the aforementioned statement represented the Commission's current position, then there would equally be no reason to propose these amendments to the Rule.

SIFMA would therefore request that the Commission clarify that the above statement in the Proposing Release was not meant to imply that a person has committed a violation of the current Rule when such person effects a short sale during the Restricted Period and then purchases securities in the offering. Rather, for a violation of the current Rule to occur, the person must have used such offering shares to "cover" such Restricted Period short sales, either directly or "indirectly," *i.e.*, through the use of impermissible "sham transactions" as outlined in the Commission's 2004 interpretation.

VIII. Debt Offerings

All of the foregoing concerns and comments expressed with respect to the scope of the proposed Rule and the potential unintended consequences apply equally with respect to debt offerings. In addition, SIFMA has further specific concerns and comments with respect to the proposed Rule's application to debt offerings, as discussed below.

As an initial matter, SIFMA notes that the practical impact of Rule 105 on "straight" debt offerings, whether investment grade or otherwise, would appear limited, with the exception of a "re-opening" of a prior debt issuance. This is based on the fact that, applying the approach that the Commission has used for purposes of Rules 101 and 102 of Regulation M, an issuer's debt security presently in distribution will not be considered the "same as" other debt securities of the same issuer that are already trading in the marketplace if the debt security in distribution has so much as a single basis point difference in coupon rate and/or a single day's difference in maturity.[17] As such, it would seem that short sales of an issuer's already outstanding debt securities would not, for purposes of Rule 105, constitute a short sale of the "offering securities" if such debt securities had even so much as a single day's difference in maturity and/or a single basis point difference in coupon rate than the debt securities presently in distribution.

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[17] Regulation M Adopting Release, 62 FR at 524 ("The elimination of the same class and series concept will reduce significantly the application of trading restrictions to nonconvertible debt securities that are not rated investment grade. Bids for and purchases of outstanding nonconvertible debt securities are not restricted unless the security being purchased is identical in all of its terms to the security being distributed. For example, Rule 101 does not apply to a security if there is a single basis point difference in coupon rates or a single day's difference in maturity dates, as compared to the security in distribution.")

However, in the case of a re-opening of a prior debt issuance (where the terms of the security being offered, including coupon rate and maturity date, would be the same as those already trading in the market), SIFMA is concerned that application of the Rule would serve to hinder the capital raising process, and result in additional costs to issuers and underwriters alike, without furthering the policy concerns at which the Rule is ultimately directed.

In this regard, SIFMA would like to reiterate a comment previously made by The Bond Market Association with respect to the Rule's application to debt offerings more generally – in short, that the Rule's prohibitions should not apply to "straight" debt offerings.[18] Rule 10b-21, the predecessor rule to Rule 105, was confined to "equity" offerings. When Rule 10b-21 was replaced by Rule 105 of Regulation M the term "equity" was dropped from the Rule, however the Commission made no mention of this change in either the Regulation M proposing release[19] or the Regulation M adopting release.[20] The lack of any discussion of this in the Regulation M proposing and adopting releases, combined with the fact that the Regulation M adopting release otherwise goes to great lengths to emphasize the regulation's very limited impact on debt offerings, suggests that the elimination of the term "equity" from the Rule years ago may not have been intentional and certainly did not benefit from the comment process that would no doubt have ensued had the Commission identified such an expansion of the rule's application.[21] Moreover, with respect to other rules regulating short sales, the

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18 See Letter from Michele C. David, BMA, to Jonathan G. Katz, SEC (January 13, 2004). This letter may be accessed on the Commission's website at http://www.sec.gov/rules/proposed/s72303/tbma011304.htm

19 Securities Exchange Act Release No. 37094 (April 11, 1996), 61 FR 17108, 17125-17126 (April 18, 1996).

20 Regulation M Adopting Release, 62 FR at 538.

21 In the Regulation M proposing release, the Commission describes the substantive difference between Rule 105, as proposed, and Rule 10b-21 as follows: "The Commission is proposing Rule 105 to replace Rule 10b-21. Rule 105, like Rule 10b-21, is designed to prevent short sales from being covered with securities obtained from an underwriter, broker, or dealer who is participating in the offering. Rule 105 would differ from Rule 10b-21 because it would cover only those short sales effected in the period commencing five business days prior to the pricing of an offering and ending with such pricing. Reducing the period of the rule's applicability is consistent with the structure of Rules 101 and 102, which provide for shorter restricted periods, and reflects the Commission's belief that such period should be sufficient to dissipate the effects of any manipulative short selling on the price of the offered security." If the Commission was at the same time intending to extend the rule's application to debt securities for the first time, it is not unreasonable to expect that an explanation and justification for such a change in the scope of the rule's application would have been provided. Likewise, in explaining the substantive difference between Rule 105, as adopted, and its predecessor rule, Rule 10b-21, the Regulation M adopting release notes that: "Rule 105 differs from Rule 10b-21 because it covers only those short sales effected in the period commencing five business days prior to the offering's pricing and ending with such pricing, rather than the potentially much longer period of Rule 10b-21, which commenced with the filing of a registration statement or Form 1-A."

Commission has expressly carved-out fixed income securities, citing in support thereof the non-manipulative potential associated with short sales in fixed income securities.[22]

SIFMA would therefore urge the Commission to take a similar approach with respect to Rule 105, which could be accomplished by clarifying that the Rule only applies to offerings of "equity" securities. As explained in the Regulation M adopting release, nonconvertible debt or preferred securities, and asset-backed securities, that are in each case rated investment grade by an NRSRO, are excepted from the prohibitions of Rules 101 and 102 of Regulation M on the "premise that these securities are traded on the basis of their yields and credit ratings, are largely fungible and, therefore, are less likely to be subject to manipulation."[23] These factors should equally militate in favor of excluding nonconvertible debt, preferred securities, and asset-backed securities from the coverage of Rule 105 and would be consistent with our prior comments to better align Rule 105 with Rules 101 and 102 of Regulation M. SIFMA believes that many of these considerations render "straight" debt securities less susceptible to manipulation (*i.e.*, they trade more on the basis of their yields and credit ratings and pricing depends more on interest rates and value of comparables) and, by historical observation, investors' shorting of debt securities in the days immediately prior to the pricing of a debt offering is less common than it is in the case of equity offerings.

For all of the foregoing reasons, SIFMA believes that the prohibitions of Rule 105 should be confined to equity offerings, as was previously the case with former Rule 10b-21 under the Exchange Act.

IX. PIPE Transactions

The Commission has raised a question in the Proposing Release about whether Rule 105 should be extended to address PIPE transactions. In this regard, however, the specific question the SEC has raised is whether the Rule should be amended to "address short sales effected during the period following the entering into of a PIPE transaction and before a registration statement for resale of the restricted securities acquired in the PIPE transaction is declared effective, or short sales that are effected at any time in connection with the PIPE transaction." [24]

SIFMA believes that such stated period of time could prohibit short sales well beyond the Restricted Period prior to pricing, and thus would be inconsistent with the activity the Rule is designed to prevent. Moreover, it is our belief that any potential

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22 Regulation SHO specifically only applies to "equity securities." *See Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO*, Q&A 1.4.

23 Regulation M Adopting Release, 62 FR at 527.

24 Proposing Release, 71 FR at 75006.

concerns that the SEC has regarding PIPEs should not properly be dealt with through amendments to Rule 105. Rather, the Commission should, and in fact has, been extremely vigilant in bringing actions, under the anti-fraud and anti-manipulation rules, for short selling activities in connection with PIPEs.

X. Question re. Extending Rule 105 to Cover "Long" Sales

In response to the Commission's question, we believe that Rule 105 should not cover any "long" sales effected during the Restricted Period. Specifically, restricting long sales would be a huge expansion of the current Rule, and would not appear to further the historical policy reasons behind the Rule. SIFMA does not believe that the Commission has provided evidence that it is necessary for such an expansion of the Rule, which would, in turn, increase the number of potential investors who could be prohibited from participating in an offering, all to the ultimate detriment of the issuer and the marketplace.

XI. Best Efforts Offering Exception

In response to the Commission's question, SIFMA believes that the exception in Rule 105(b) for offerings that are not conducted on a firm commitment basis should be retained. Registered offerings on a non-firm commitment basis often involve continuously-offered securities which are offered and sold when demand exists at the current market price. These offerings do not involve the type of discount which provides a motivation to "capture the discount by aggressively short selling just prior to pricing," and, as a result, do not raise the policy concern that the proposed rule changes are intended to address. An example is ETFs, which are typically comprised of an underlying basket of securities based on a broad, diversified index. They are sold in a continuous, non-firm commitment offering at a price based on the market price of the ETF at the time of sale. As the SEC has recognized, arbitrageurs play a crucial role in connection with the trading and pricing of ETF shares.[25] Arbitrageurs buy ETF shares when the ETF is trading at a price less than its NAV, and sell ETF shares when the ETF is trading a price greater than its NAV. The sales may be short sales. These arbitrage activities help ensure that ETF shares trade at or near their NAV. Firms engaged in these arbitrage activities also offer and sell the securities in a continuous, non-firm commitment registered offering. Without the Rule 105 exception for offerings conducted other than on a firm commitment basis, it would not be possible for arbitrageurs to continue to engage in these beneficial activities. This would have a significant detrimental impact on the pricing efficiency of the ETF marketplace.

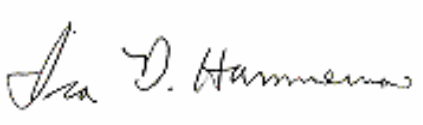
[25] *See* Investment Company Release No. 25258 (Nov. 8, 2001).

XII. Conclusion

SIFMA respectfully urges the careful consideration of the above comments and questions regarding the Proposing Release, as it believes that certain of the proposed amendments and other items raised by the Commission in the Proposing Release do not appear to be in the best interests of the U.S. capital markets, and would create additional risks and impose substantial costs upon offering participants that would be far greater than the potential benefits that might be received. In light of the potentially negative consequences of the proposed amendments, SIFMA would respectfully urge the Commission to consider the alternatives suggested above, and solicit further public comment through a further proposing release, rather than proceeding straight to adoption.

If you have any questions or require additional information, please do not hesitate to contact the undersigned at 202-434-8400, Amal Aly, SIFMA Vice President and Associate General Counsel, at 212-608-1500 or Mary Kuan, SIFMA Vice President and Assistant General Counsel, at 646-637-9220. Thank you for your attention to this request.

Sincerely,



Ira D. Hammerman
SIFMA Managing Director and
General Counsel

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul Atkins, Commissioner
The Hon. Roel Campos, Commissioner
The Hon. Annette Nazareth, Commissioner
The Hon. Kathleen Casey, Commissioner
Dr. Erik Sirri, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
James A. Brigagliano, Associate Director, Division of Market Regulation
Josephine Tao, Branch Chief, Division of Market Regulation
Barbara J. Endres, Sidley Austin LLP
Kevin J. Campion, Sidley Austin LLP