



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

August 23, 2012

The Honorable Darrell E. Issa
Chairman
Committee on Oversight and Government Reform
United States House of Representatives
2157 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Issa:

Thank you for your letters of June 19, 2012 and July 31, 2012 concerning the regulatory structure relating to initial public offerings.

A properly functioning IPO market is of critical importance to the health of our economy, and I appreciate the opportunity to continue to engage in a dialogue with you on this topic. Ensuring an appropriate regulatory structure for IPOs is a key part of the Securities and Exchange Commission's mission to protect investors, facilitate capital formation, and maintain fair and orderly markets. In your most recent letter, you asked me to consider whether a concept release would be an effective way to consider reforms to the IPO regulatory regime, including seeking input on the concepts underlying the questions discussed below. As you know, the recently enacted Jumpstart Our Business Startups Act¹ has made, and will continue to make, significant changes to the way IPOs are conducted and the permissible communications in both IPOs and unregistered offerings. We are monitoring the impact of these changes. Additionally, I have previously asked Commission staff to review our communications rules applicable to all registered offerings. This review is ongoing. As part of this effort, I have asked the staff to consider the use of a concept release as a tool to gain insight from companies, investors, and other market participants about further reforms.

Your first letter set out a series of questions on a variety of topics relating to the process and regulatory framework for IPOs. As background for the responses I have provided to your specific questions, I have first addressed the two primary concerns you raised relating to the regulatory framework applicable to IPOs – namely, that (1) current securities laws and regulations dictate the manner in which IPOs are conducted and priced and (2) restrictions on communications and the potential liability of issuers and underwriters to investors create an informational disadvantage for retail investors. I also have included information about registered offerings that have used auction-based pricing. Your first letter also asks for the Commission's view with respect to certain matters addressed in the letter. Please note that, unless specified in

¹ Pub. L. No. 112-106, 126 Stat. 306 (2012) (JOBS Act).

this letter, this Commission has not expressed a view on these particular matters. In addition, your first letter refers to the IPO for Facebook, Inc. conducted in May 2012, and includes a discussion of, and questions focusing on, specific details about the offering. While I cannot comment in this letter about a specific registrant or transaction, I have sought to address your questions about the IPO process and regulatory framework in a manner that will provide a useful starting point for a discussion of both the regulatory and market-driven forces that shape how IPOs are currently conducted, including pricing and allocation decisions and the dissemination of information to potential investors.

IPO Pricing and Regulatory Framework

Your first letter expresses a concern that issuers and underwriters are able to wield discretion in the pricing of IPOs in a manner that ultimately harms investors and the U.S. capital markets. A corollary concern raised in your first letter is that the client relationships that underwriters maintain with issuers and investors create conflicts of interest that result in distortions in IPO pricing and share allocation that negatively impact companies and retail investors. I recognize that our regulatory system should address pricing practices and conflicts of interest that could harm investors and the U.S. capital markets.

Your first letter also asks about the securities law and regulatory impediments to the use of alternative pricing methods, such as modified “Dutch auctions,” which you indicate could yield a more efficient price discovery process and ultimately a more “market-based” price for IPO securities. It is important to note that neither the Securities Act of 1933 (Securities Act), nor the rules promulgated under it, prescribe or restrict the manner in which the price of securities is determined, or the underwriting arrangements, if any, that must be used in IPOs, including the use of alternative pricing methods such as modified Dutch auctions or internet auctions.² Notwithstanding the availability of alternative pricing methods, it appears that the method overwhelmingly chosen by companies in the United States for the distribution of securities in an IPO is through a syndicate of investment banking firms that engage in a marketing and “book-building” process, who then agree with the company, on a firm commitment basis, to purchase the securities at a discount from the IPO price and resell them to investors at the IPO price.³

² There have been approximately 22 auction-based IPOs registered with the Commission, with the first being conducted in 1999. See J. Eaglesham and T. Demos, *Lawmakers Push for Overhaul of IPO Process*, Wall Street Journal (June 22, 2012) (citing Dealogic). In the same period, there have been approximately 1,949 IPOs registered with the Commission. In addition, studies have indicated that a form of book-building was used in most global equity financing markets during the 1990s. See, e.g., F. Degeorge, F. Derrien and K. L. Womack, *Analyst Hype in IPOs: Explaining the Popularity of Bookbuilding*, Review of Financial Studies 20 (4), 1021-1058 (2007); A.P. Ljungqvist, T. Jenkinson and W.J. Wilhelm, *Global Integration in Primary Equity Markets: The Role of U.S. Banks and U.S. Investors*, Review of Financial Studies 16, 63-99 (2003); and A.E. Sherman, *Global Trends in IPO Methods: Book Building Versus Auctions With Endogenous Entry*, Journal of Financial Economics 78 (3), 615-649 (2005) (reporting that in virtually all countries where book-building has been introduced, preexisting mechanisms, including auctions, have disappeared or lost a significant share of the market).

³ In the United States, the majority of IPOs have historically been conducted on a “firm commitment” basis, which means that the underwriters commit to purchase all shares in the offering at a negotiated discount and resell the shares to investors at the public offering price. In a firm commitment underwriting, any securities not resold to the public are paid for and held by the underwriters for their own account, and, therefore, the underwriters bear the risk

Book-building refers to the process by which one or more underwriters, at the direction of an issuer, gather and assess potential investor demand for an offering of securities and seek information important to help formulate their recommendation to the company as to the ultimate size and pricing of the offering.⁴ Under the federal securities laws, preparations for the book-building process can start with initial communications by the underwriters with institutional and other investors as soon as a company has filed the initial draft of its registration statement.

The “road show,” which is conducted by companies and their underwriters to market the offering to potential, typically institutional, investors, is expected to provide the company, underwriters, and potential investors the opportunity to gather important information from each other. Investors typically seek information about a company, its management, and its future plans and prospects. A company and its underwriters generally seek information about interest level from investors and indications as to a valuation that an investor may place on the company’s business. The process is designed to assist the underwriters in assessing demand for the offering, with the goal of improving accuracy in the valuation of the offering. The demand of the investors consulted during the book-building process is expected to reflect the value these investors place, and the value they expect the market to place, on the company, both initially and after the IPO. In conjunction with the road shows, there are discussions between the underwriters’ sales representatives and prospective investors to obtain investors’ views about the company and the offered securities, and to obtain indications of the investors’ interest in purchasing the underwritten securities in the offering at particular prices.⁵ I understand that these discussions, which are conducted both as part of a road show and more informally by underwriters’ sales representatives, typically take place with institutional investors.

The information that underwriters typically attempt to gather from prospective institutional investors during the IPO book-building process includes:

- A prospective investor’s evaluation of the company’s products/services, earnings, history, management, and prospects.
- A prospective investor’s valuation of the securities being offered.
- The amount of shares a prospective investor seeks to purchase in the offering at particular price levels (*i.e.* indications of interest or conditional offers to buy).

of not being able to sell any of the shares. In contrast, in a “best efforts” offering, the underwriters agree to use their best efforts to sell all the offered shares to the public, but they do not guarantee that any shares will be sold. As with book-building, an auction-based pricing method can be conducted on a firm commitment or a best efforts basis.

⁴ See generally L.M. Benveniste and W.J. Wilhelm, *Initial Public Offerings: Going by the Book*, *Journal of Applied Corporate Finance* 10 (1997); L.M. Benveniste and P.A. Spindt, *How Investment Banks Determine the Offer Price and Allocation of Initial Public Offerings*, *Journal of Financial Economics* 24 (1989). See also *Commission Guidance Regarding Prohibited Conduct in Connection with IPO Allocations*, Release No. 33-8565 (April 7, 2005) (Regulation M Guidance).

⁵ See *id.*

- At what prices the prospective investor expects the shares will trade after the offering is completed (*e.g.*, where the stock will be trading three to six months after the offering).
- Whether the prospective investor intends to hold the securities long term as an investment, or, instead, expects to sell the shares in the immediate aftermarket.
- The prospective investor's desired long-term future position in the security being offered or in the relevant industry, and the price or prices at which the investor might accumulate that position.⁶

By aggregating the information obtained from certain potential investors during the book-building process with other information (such as global economic indicators and conditions in the markets generally), the company and the underwriters will negotiate the size and pricing of the offering and the underwriters will determine how to allocate the IPO shares to purchasers. If, at the time of pricing, the company and underwriters are not comfortable that all of the securities can be sold, the size of the transaction may be reduced, the offering price may be reduced to a level more consistent with indications of interest, or the offering may be postponed in its entirety. Alternatively, if an offering is oversubscribed, the offering size or offering price may be increased, or both. Consistent with state corporate law, however, the company's board of directors must approve the actual pricing of an IPO, including the offering price and the number of shares to be sold by the company.⁷ In this process, neither the underwriters nor the company alone can dictate the price. The underwriters are not required to accept the company's desired price, and the company can decide not to proceed with the offering if it is not comfortable with the pricing terms.

Your first letter raises a concern that the focus on institutional investors as the investor base for IPOs discounts the value of companies seeking to go public, and that, instead, the IPO price should solely reflect the price that all investors are willing to pay – a “true market price.” I recognize that there are differing viewpoints on this issue. As described in more detail below, I understand that there are certain benefits for issuers, underwriters, and investors that flow from allocations to institutional investors. I also recognize, however, that there are those who believe that a focus on institutional investors can result in inefficient pricing that ultimately is to the detriment of issuers and, potentially, to retail investors.

⁶ See Regulation M Guidance. See also W.J. Wilhelm, *Bookbuilding, Auctions, and the Future of the IPO Process*, *Journal of Applied Corporate Finance* 17, 55-66 (2005); and J.R. Ritter, *Investment Banking and Securities Issuance*, *Handbook of the Economics of Finance* 1 (1), chapter 5, 255-306 (2003) (providing related institutional details).

⁷ See, *e.g.*, Delaware General Corporate Law §§ 152-153. For a further discussion, see 2003 NASD/NYSE IPO Advisory Committee Report, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p010373.pdf>, which also notes that, in making its pricing determination, a company's board of directors has, under state law, a fiduciary duty to act in the best interests of the corporation and its shareholders. It is the board's responsibility to use its good faith business judgment when disposing of the issuer's assets, including its capital stock in an IPO, by weighing the key considerations of the transaction, including the long-term implications of various pricing scenarios.

There are a number of benefits that have been articulated for a focus on institutional investors in the price discovery process. Among these is the view that institutional investors can provide researched and well-informed feedback on the pricing of the security, which can assist the company and the underwriters in establishing a better informed offer price.⁸ Additionally, institutional investors tend to participate in a number of offerings, and the repeat involvement of institutional investors mitigates the positive and negative effects of pricing uncertainty over time and ensures there is sufficient demand for offerings even where there is price uncertainty.⁹ Similarly, offering participants have emphasized the importance of finding institutional investors as integral long-term holders during the book-building process.¹⁰ Certain studies have shown that allocations in IPOs are directed towards investors who will be long-term holders rather than investors who will immediately sell in the aftermarket.¹¹ These studies assert that the IPO price is set, not to reflect aggregate demand generally, but to take into account the price needed to gain the interest and ownership of long-term holders.¹² As a result, under this theory the offering price for an IPO is not simply what all investors are willing to pay or what the underwriters believe the issuer's business is "worth," but instead reflects the discount necessary to attract key institutional investors who are expected to be making a long-term investment commitment.¹³

⁸ See, e.g., R. Aggarwal, N. Prabhala and M. Puri, *Institutional Allocation in Initial Public Offerings: Empirical Evidence*, *Journal of Finance* 57 (3), 1421-1442 (2002) and K.W. Hanley and W.J. Wilhelm, *Evidence on the Strategic Allocation of Initial Public Offerings*, *Journal of Financial Economics* 37, 239-257 (1995) (concluding that institutions-dominated IPO allocations perform better in the short-run and the long-run as they exploit private information); see also L. Field and M. Lowry, *Institutional Versus Individual Investment in IPOs: The Importance of Firm Fundamentals*, *Journal of Financial and Quantitative Analysis* 44 (3), 489-516 (2009) (concluding that institutions' higher post-IPO returns should be mainly attributed to their better interpretation of readily available public information when compared to post-IPO returns of non-institutional investors).

⁹ See T. J. Chemmanur, H. Gang and J. Huang, *The Role of Institutional Investors in Initial Public Offerings*, *Review of Financial Studies* 23 (12), 4496-4540 (2010) (finding that institutions with multiple allocations in IPOs appear to be playing a supportive role in the IPO aftermarket by holding allocations of securities with weaker post-issue demand for a longer period and that these institutions were compensated for their IPO participation in the form of more IPO allocations from underwriters).

¹⁰ For example, in the largest IPO in U.S. history, it was reported that the lead underwriters "scrubbed the book of potential buyers to make sure that shares were going into the hands of holders, rather than quick sellers looking to make fast money." K. Benner, *Visa IPO Prices at a record \$17.9B*, *Fortune* (March 19, 2008). In addition, underwriters keep track of flipping activity by initial investors through the Depository Trust Company's IPO Tracking System, which was implemented in 1996. See *Order Approving a Proposed Rule Change Implementing the Initial Public Offering Tracking System*, Release No. 34-37208 (May 13, 1996).

¹¹ See, e.g., T. Jenkinson and H. Jones, *Bids and Allocations in European IPO Bookbuilding*, *Journal of Finance* (Oct. 2004); and R. Aggarwal, *Allocation of Initial Public Offerings and Flipping Activity*, *Journal of Financial Economics* (2003).

¹² Recent studies have found that this "holding" rationale provides an explanation for both IPO underpricing and a preference for book-building. See S. Banerjee, R. Hansen and E. Hrnjic, *IPO Underpricing to Attract Buy-and-Hold Investors* (2008), available at <http://apps.olin.wustl.edu/FIRS/PDF/2009/698.pdf>; see also V. Goyal and L. Tam, *Investor Characteristics, Relationships and IPO Allocations* (2009), available at http://www.isid.ac.in/~pu/conference/dec_09_conf/Papers/VidhanGoyal.pdf.

¹³ See *id.*; see also B. Carter and F.H. Dark, *Underwriter Reputation and Initial Public Offers: The Detrimental Effects of Flippers*, *Financial Review* 28 (2), 279-3-1 (1993) (concluding that sales of securities immediately following the IPO has a detrimental effect on early price performance).

Though the phenomenon of IPO underpricing has been a focus of academic study for more than forty years, as described in greater detail in responses to Questions 1 through 5, there is no consensus in the literature on the theoretical cause for underpricing.¹⁴ Unlike an acquisition transaction in which all the equity is sold (typically at a premium reflecting that “control” element), most companies offer only a fraction of their total outstanding shares in an IPO. Studies have shown that the median float has been between 20% and 30% annually over the past decade.¹⁵ As a result, only a portion of a company’s shares is discounted, and subsequent issuances are valued at or very near the prevailing market price, with little or no discount. The fact that only a portion of a company’s shares are being sold has been asserted to explain why companies may be willing to agree to a discount in their IPO pricing, so they can attract buy-and-hold investors and, in particular, well-known, large institutional holders, to gain access to public equity markets for capital through follow-on equity issuances, which would be at prices that are more reflective of market price, and to gain other benefits of being a public company.¹⁶

Communications with Investors During an IPO

Your first letter also raises questions as to whether the communications rules applicable to IPOs and the legal liability provisions of the Securities Act create barriers to communications with investors, particularly in the context of rules relating to analyst research reports, in a manner that causes an informational advantage for institutional investors over retail investors. Ensuring that our communications rules facilitate, not hinder, the ability of an issuer to communicate with all investors is an important aspect of the staff’s review of these rules.

The Securities Act restricts the types of offering communications that an issuer and other parties subject to its provisions (such as underwriters participating in the offering) may use during an IPO.¹⁷ These restrictions, and the Securities Act’s focus on the use of a statutory prospectus in connection with offers and sales in registered offerings, arise from the premise that all investors should have access to comprehensive, balanced information about the issuer and the offering that facilitates investment decisions.¹⁸ This traditional emphasis on the statutory prospectus as the primary source of information for investors, and the Securities Act liability associated with the information in that prospectus, was intended to encourage widespread

¹⁴ See J.R. Ritter and I. Welch, *A Review of IPO Activity, Pricing and Allocations*, Journal of Finance (2002) (noting “[i]n our view there is no single dominant theoretical cause for underpricing”).

¹⁵ See J.R. Ritter, *Initial Public Offerings: Tables Updated Through 2011*, Figure 3, (May 31, 2012), available at http://bear.warrington.ufl.edu/ritter/IPOs2011Statistics5_31_12.pdf.

¹⁶ See, e.g., I. Welch, *Seasoned Offerings, Imitation Costs, and the Underpricing of Initial Public Offerings*, Journal of Finance 44, 421-450 (1989).

¹⁷ In my letter to you dated April 6, 2011, I also described the regulatory framework governing communications in both registered and private offerings.

¹⁸ See, e.g., *Publication of Information Prior to or After the Effective Date of a Registration Statement*, Release No. 33-3844 (Oct. 8, 1957).

dissemination of a reliable and thorough source of information about the issuer and the offering.¹⁹

Over the years, the Commission has taken a number of steps to facilitate continued communications related to public offerings, including IPOs. In one important 2005 reform of the registration and offering process, the Commission adopted a comprehensive set of new rules that relaxed restrictions on communications by issuers during the registered offering process, both in IPOs and registered offerings following IPOs.²⁰ These changes significantly liberalized an issuer's ability to communicate during public offerings, thereby allowing more information to reach investors. The following are examples of these changes that impacted the IPO process:

- Issuers were provided a new safe harbor, available at any time in the registration process, so they know they can continue to communicate factual business information in the ordinary course of their business without being concerned that the communication would raise gun-jumping or similar concerns.²¹
- Issuers, underwriters, and other offering participants were provided with an expanded safe harbor, available after the filing of a registration statement, covering offering announcements that now includes additional items, such as routine communications regarding the issuer, the offering, and procedural matters (such as announcements about the schedule of the IPO or about account-opening procedures).²²
- Issuers, underwriters, and other offering participants are permitted, after the filing of a registration statement, to use "free writing prospectuses" that are filed on the Commission's EDGAR system to communicate new and updated information to potential investors (before this change, many of these communications would have been viewed as illegal prospectuses under the Securities Act).²³

¹⁹ See, e.g., *Offers and Sales of Securities by Underwriters and Dealers*, Release No. 33-4697 (May 28, 1964).

²⁰ See *Securities Offering Reform*, Release No. 33-8591 (July 19, 2005) (Securities Offering Reform Release).

²¹ See Securities Act Rule 169. This safe harbor applies to factual information about the issuer, its business or financial developments, or other aspects of its business, as well as advertisements of, and other information about, the issuer's products and services. It excludes offering-related information and forward-looking information.

²² See Securities Act Rule 134.

²³ See Securities Act Rules 164 and 433. "Free writing prospectus" is broadly defined and generally covers any written offer, including electronic communications and media broadcasts, which is not a statutory prospectus. See Securities Act Rule 405. There are no specific disclosure requirements for a free writing prospectus. The rules also permit information in a free writing prospectus to go beyond the information that is contained in the prospectus included in the registration statement, so long as it does not conflict with the information in the prospectus. Free writing prospectuses generally must be preceded or accompanied by a preliminary prospectus, which may be accomplished in electronic communications by providing a hyperlink to the filing.

- Issuers are permitted to use electronic roadshows, with conditions tied to making sure the information is filed on EDGAR or is otherwise generally available to the public.²⁴
- Issuers are permitted to communicate with unpaid, unaffiliated media during offerings.²⁵

In addition, the Commission has long recognized the value of research reports in continuing to provide the market and investors with information about public companies. For example, in 1970, the Commission adopted safe-harbor exemptions to make it clear that continued analyst research coverage does not alone constitute an unlawful offer.²⁶ In 2005, the Commission adopted rule amendments that broadly defined what would constitute a research report and expanded the scope of the safe harbors for the publication and distribution of research reports during registered offerings.²⁷ In the context of an IPO, a broker or dealer that is not participating in the IPO may initiate coverage or continue to publish research reports about the issuer, without the research report being considered an unlawful offer and without the broker or dealer being deemed an underwriter in that IPO.²⁸ This means that research analysts affiliated with brokers that are not participating in the IPO are not subject to the communications restrictions to which issuers and offering participants are subject. For research reports prepared by research analysts affiliated with brokers that are participating in the IPO, the Commission's rules would permit an issuer or offering participant to use or distribute (or include a hyperlink to) these research reports, as long as the issuer or participant that uses or distributes a research report in this manner complies with the rules applicable to free writing prospectuses. Despite the flexibility provided in the rules, I understand that in practice, without taking into account developing practices as a result of the JOBS Act, research reports are not disseminated to investors as part of an offering.²⁹

²⁴ See Securities Act Rule 433.

²⁵ See Securities Act Rules 164 and 433(f). When an issuer or offering participant provides information to the media about the issuer or the IPO that ordinarily would be viewed as an "offer," the media publication is generally treated as a free writing prospectus of the issuer or offering participant in question, provided that the media publication is unpaid and unaffiliated with the issuer.

²⁶ See *Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933*, Release No. 33-5101 (Nov. 19, 1970).

²⁷ See Securities Act Rules 137, 138, and 139. The rules define "research report" as a written communication that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision. See Securities Act Rule 405. This definition is intended to encompass all types of research reports, whether issuer-specific or industry research separately identifying the issuer.

²⁸ See Securities Act Rule 137. Note that, outside of the IPO context, offering participants are permitted to continue to publish research about certain issuers. See Securities Act Rule 139.

²⁹ Under Title I of the JOBS Act, the research report rules are relaxed for brokers participating in an IPO for an emerging growth company. The JOBS Act defines an emerging growth company as an issuer that had total annual gross revenues of less than \$1 billion during its most recently completed year. Specifically, Section 105(a) of the JOBS Act provides that a broker-dealer that is participating or will participate in an IPO for an emerging growth company may publish research reports about the company, without such reports being deemed a prospectus or being

The Financial Industry Regulatory Authority (FINRA) rules³⁰ relating to research reports are designed to promote objective and reliable research. Their rules address the distribution of research by interested parties during the time period immediately after an IPO, often referred to as the “research quiet period.”³¹ Specifically, FINRA rules adopted to implement the requirements of Section 15D(a)(2) of the Securities Exchange Act of 1934 (Exchange Act) limit the ability of offering participants to publish or distribute research reports for specified periods after an IPO depending on the role that the broker-dealer plays in the offering.³² FINRA does, however, allow research reports to be published during these quiet periods if they concern the effects of significant news or a significant event on the subject company provided that the FINRA member’s legal or compliance personnel authorize it prior to publication.³³ Further, as only those FINRA members that are underwriting the offering are subject to these requirements, other brokers or dealers may publish research at this time. As such, the information may be available to investors.

Another factor that has been indicated as impacting the dissemination of research reports is the proprietary nature of the analysis. Although the Commission has acknowledged the value of research to investors, the securities laws do not require broker-dealers to make their research reports, or related estimates regarding an issuer’s future results, publicly available. Additionally, FINRA rule interpretations permit its members to provide different research products and services to different classes of customers. These classes can be based on different factors, including portfolio size and fees paid to the broker.³⁴

deemed an offer of the securities sold in the offering. Section 105 also removes certain restrictions on the timing of post-offering distribution of research by offering participants, such as the FINRA rules for research quiet periods, and allows research analysts to participate with investment bankers in certain communications with company management.

³⁰ During the period 1996 to 2008, I held various senior positions at FINRA and its predecessor, the National Association of Securities Dealers (NASD), including chief executive officer of FINRA. During this time, certain of the FINRA rules, or their predecessor NASD rules, discussed in this letter were adopted.

³¹ In proposing these rules, the stated purpose of the quiet period was, in part, to “reinforce the prohibition against a member offering to reward a subject company for its securities underwriting business by publishing favorable research right after the completion of the distribution.” It also was stated that the quiet period for an IPO permits market forces to determine the price of the security in the aftermarket unaffected by research reports issued by firms with the most substantial interest in the offering. *See Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. and Amendment No. 1 to the Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest*, Release No. 34-45908 (May 10, 2002).

³² *See, e.g.*, NASD Rule 2711(f). Managing and co-managing underwriters cannot publish or distribute research for 40 days following an IPO, and all other offering participants cannot publish for 25 days. FINRA is considering amendments that would reduce these time periods to ten days. *See* FINRA Regulatory Notice 08-55 (Oct. 2008). Pursuant to Section 105(d) of the JOBS Act, these restrictions do not apply to the IPOs of emerging growth companies.

³³ *See, e.g.*, NASD Rule 2711(f)(1)(B)(i).

³⁴ *See* FINRA Regulatory Notice 08-55 (Oct. 2008). Under these interpretations, however, members may not differentiate a research product or service using the timing of receipt of a recommendation, rating, or other

Registered Offerings Using Auction-Based Pricing

Companies have, for many years, used auction procedures in registered securities offerings to determine the public offering price. Such methods were first employed in the context of registered debt offerings³⁵ but have since been used, albeit infrequently, in equity offerings. The first IPO registered with the Commission that included an auction pricing mechanism was conducted in 1999. Since then, approximately 21 other companies have completed IPOs in which auction procedures were used to help inform the public offering price.³⁶ Auction-based pricing methods also have been used in connection with shares registered for resale by shareholders and in issuer share repurchases.

In an IPO, sales cannot occur until an issuer's registration statement is declared effective by the Commission's staff following completion of its review process. For purposes of the registration provisions of the Securities Act, a "sale" generally occurs when the investor becomes obligated to purchase the offered securities. Thus, in a typical firm commitment underwritten IPO, I understand that, although underwriters will begin soliciting indications of interest in an offering while the registration statement review is still pending, the price is finalized and sales are completed only after the registration statement is declared effective by the Commission's staff. Commission rules require that if the company circulates a preliminary prospectus for its IPO prior to effectiveness – for example, in connection with a road show – the prospectus must disclose a *bona fide* estimate of the maximum offering price range and the maximum number of securities the company plans to offer for sale.

The requirement for disclosure of a price range stems from the Securities Act, which requires a registration statement to include the proposed public offering price (or the method by which the price is computed).³⁷ When the offer and sale of common stock is being registered where there is no established public trading market for such common stock, such as in an IPO, the outside front cover of the prospectus must include a *bona fide* estimate of the range of the maximum offering price of the shares.³⁸ The prospectus also is required to include a description of the various factors considered in determining the offering price.³⁹

Auctions in the IPO context generally employ a sealed-bid uniform-price auction model, commonly referred to as a "modified Dutch auction." As with registration statements for IPOs using a book-building process, registration statements for modified Dutch auction IPOs must

potentially market moving information as the basis for differentiation, nor may a member make distinctions between research products, in each case as a means to allow certain customers to trade in advance of other customers that are entitled to the same research product.

³⁵ See *Exxon Corp.*, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 1245 (May 9, 1977).

³⁶ See note 2, *supra*, and accompanying text.

³⁷ See Securities Act Schedule A.

³⁸ See Item 501(d)(1) of Regulation S-K.

³⁹ See Item 505 of Regulation S-K.

disclose information about the issuer and the offering, including a *bona fide* price range and the maximum number of securities the issuer plans to offer. The prospectus must also discuss the bidding and auction procedures, explain how the final offering price will be determined, and explain how the company will allocate shares in the offering if it receives successful bids for a greater number of shares than are available for sale. After circulation of a preliminary prospectus, the company may begin to receive bids in the form of conditional offers to purchase. I understand that potential investors will place bids specifying the price at which they wish to purchase shares and the number of shares they desire to purchase, and the issuer, along with the underwriters, will use the submitted bids to determine a “clearing price” at which all of the offered shares will be able to be sold. The auction process will award, or sell, shares to the bidders whose bid prices are at or above the clearing price. Although the different bidders may submit bids at different prices, all bidders who are allocated shares in the offering pay the same final offering price. For example, assume a company plans to sell 10,000 shares and receives the following bids:

Bidder A	3,500 shares @ \$20.00 per share
Bidder B	3,000 shares @ \$18.00 per share
Bidder C	3,500 shares @ \$17.00 per share
Bidder D	4,000 shares @ \$16.50 per share
Bidder E	2,000 shares @ \$16.00 per share

In this example, the clearing price would be \$17.00, as that is the highest price at which the company has received bids for all 10,000 shares it plans to sell. Bidders A, B, and C will all purchase shares in the IPO at price of \$17.00 per share, even though Bidders A and B had made bids in excess of the purchase price. Bidders D and E will not receive any shares.

Pursuant to the Commission’s rules, the bidding process in auction-based IPOs generally begins prior to effectiveness of the registration statement. Although Section 5 of the Securities Act prohibits sales prior to effectiveness, auctions can be conducted in compliance with Securities Act Rule 134, which permits a company to receive pre-effective offers to purchase securities so long as no offer to purchase is accepted and no part of the purchase price is received prior to effectiveness of the registration statement. Rule 134(d) also requires that potential purchasers be able to withdraw or revoke any pre-effective offers to purchase at any time prior to notice that the offer to purchase has been accepted, which must be given after the effective date of the registration statement. The staff of the Commission’s Division of Corporation Finance has provided interpretive guidance to companies and underwriters on procedures that may be followed to conduct auction-based offerings in compliance with Section 5.⁴⁰

⁴⁰ See, e.g., *Wit Capital Corp.*, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 620 (July 14, 1999) (relating to firm-commitment underwritten auction-based IPOs); *Bear, Stearns & Co., Inc.*, SEC No-Action Letter, 2000 SEC No-Act. LEXIS 748 (July 20, 2000) (relating to modified Dutch auctions of debt securities by reporting issuers); *Wit Capital Corp.*, SEC No-Action Letter, 2000 SEC No-Act. LEXIS 749 (July 20, 2000) (relating to use of an auction method in registered follow-on, secondary, and combination equity offerings by reporting issuers); *W.R. Hambrecht & Co.*, SEC No-Action Letter, 2000 SEC No-Act. LEXIS 737 (July 12, 2000) (relating to auctions of debt securities by reporting issuers); *Exxon Corp.*, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 1245 (May 9, 1977) (relating to Dutch auctions of registered debt securities).

In the auction-based IPOs registered to date, companies and their underwriters have typically reserved the right to set the final offering price lower than the clearing price obtained in the auction.⁴¹ The prospectus for these IPOs generally discloses that the final offering price will be determined through negotiations between the company and the underwriters and that the clearing price revealed through the bidding process will be the primary factor considered. Typically, however, the prospectus in these offerings also discloses that the company and underwriters will also consider other factors, such as general market trends or conditions, the underwriters' assessment of the issuer's management, operating results, capital structure and business potential, the demand for and price of similar securities of comparable companies, how widely the shares would be distributed, and the expected stability of the trading price following the offering. Moreover, companies have the right to change the number of shares offered from the expected offering size disclosed in the prospectus. This can have the effect of raising or lowering the clearing price.⁴²

Responses to Questions

- 1. Given the IPO process provided for under the '33 Act enables the underwriter and issuer to exercise substantial discretion when determining the initial price for a public share offering, can this exercise of discretion lead to pricing error?**

As discussed above, an IPO conducted using a book-building method is one in which the offering price is set based on negotiations between the issuer and underwriter after the issuer and underwriter consider formal indications of interest and other information gathered from potential investors in the book-building process. This information can include general market trends or conditions, the demand for and price of similar securities of comparable companies, how widely the shares would be distributed, and the expected stability of the trading price following the offering.

Over the past four decades, it has been reported that there has been, on average, a 17.9% underpricing of IPOs.⁴³ Although IPO underpricing is a well-documented occurrence, experts do not agree on whether IPO underpricing actually reflects "pricing error." For example, a number of experts assert that the systematic and consistent underpricing of IPO issuances is not

⁴¹ See R. Jagannathan, A. Jirnyi and A. Sherman, *Why Don't Issuers Choose IPO Auctions? The Complexity of Indirect Mechanisms* (July 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330691, at 43.

⁴² In order to assure that an investor's investment decision is based on accurate information about potential pricing terms, where either the final offering price is set outside the previously-disclosed expected price range or the company changes the size of the offering, Commission staff may require an amendment to the prospectus, reconfirmation of bids, or both. Additionally, as is the case for all registered offerings, certain types of changes to the planned offering also could require the company to file a new registration statement or a post-effective amendment. For example, a company that decides to sell more securities than it had registered would need to file a new registration statement to do so, which would become effective automatically if the aggregate offering size is increased by no more than 20%.

⁴³ See J.R. Ritter, *Money Left on the Table in IPOs – Yearly*, December 2011 (Mean First-day Returns and Money Left on the Table, 1990-2011), available at http://bear.warrington.ufl.edu/ritter/Money_yearly12_22_11.pdf.

necessarily an error. Experts asserting this viewpoint believe underpricing is designed to protect against certain underwriting and investment risks. The most common explanations for underpricing provided in this research are that it compensates for information provided by investors, protects uninformed investors, protects against litigation risk resulting from residual uncertainty in the pricing process, and attracts long-term investment by regular, reputable investors that assists in future capital raising, while others have asserted that IPO underpricing is designed by underwriters to reward favored clients and themselves.⁴⁴

2. Do those in the position to determine IPO pricing, such as the underwriter(s), suffer any conflicts of interest? Please explain.

As discussed above, in a typical IPO, the offering price is determined through negotiations between the managing underwriters and the issuer. The role of an underwriter, however, does present circumstances that raise potential conflicts of interest.

The underwriter is hired by the issuer, and thus, in some respects, the underwriter's primary interest in the IPO is representing the interests of the issuer. Success in the representation will likely be evaluated, in part, on the pricing of the IPO and the post-IPO trading of the issuer's stock. Some may argue that actions by the underwriter, such as pricing recommendations that result in underpricing, could weigh heavily on future underwriting mandates or other advisory opportunities with that issuer. Additionally, a pattern of underpricing could impact whether other issuers would consider retaining the underwriter.

While some have asserted that underwriters' interests are generally aligned with the issuer to price the IPO in a manner that will achieve both the issuer's financing goals and strong trading performance, others have asserted that underwriters also have an interest in managing their sell-side customer relationships, which may be in conflict with an issuer's goals.⁴⁵ For example, underwriters often have ongoing relationships with institutional investors relating to a variety of different activities. Some have suggested that protecting this relationship helps ensure adequate demand for future offerings and mitigates the positive and negative effects of pricing uncertainty over time.⁴⁶ It has also been observed that underwriters could be incentivized to underprice an IPO so that they can engage in allocation practices that reward certain customers

⁴⁴ See, e.g., J.R. Ritter, *supra* note 6; L. M. Benveniste and P. A. Spindt, *supra* note 4; K. Rock, *Why New Issues are Underpriced*, *Journal of Financial Economics* 15, 187-212 (1986); M. Lowry and S. Shu, *Litigation Risk and IPO Underpricing*, *Journal of Financial Economics* 65, 309-335 (2002); K.W. Hanley and G. Hoberg, *The Information Content of IPO Prospectuses*, *Review of Financial Studies* 23, 2821-2864 (2010); S. Banerjee, R. Hansen and E. Hmjic, *supra* note 12.

⁴⁵ See T. Loughran and J. R. Ritter, *Why Don't Issuers Get Upset About Leaving Money on the Table in IPOs?*, *Review of Financial Studies* 15 (2), 413-444 (2002) (relating to underpricing and the conflicts of interest that can develop between underwriters and issuers when determining the IPO offer price).

⁴⁶ See, e.g., T. J. Chemmanur, H. Gang and J. Huang, *supra* note 9.

with an aftermarket price increase, or “pop,” that can result following underpricing.⁴⁷ In turn, those customers may generate future investment banking or other revenues for the underwriter.⁴⁸

While there may be certain conflicts of interest associated with IPO pricing and the role of underwriters in offerings, Commission and FINRA rules seek to address these conflicts.⁴⁹ For example, Regulation M under the Exchange Act⁵⁰ proscribes certain activities that could manipulate the price of an offering by those in a position to influence IPO prices. Regulation M is designed to prohibit activities that could artificially influence the market for the offered security, including, for example, supporting the offering price by creating the exaggerated perception of scarcity of the offered security or creating the misleading appearance of active trading in the market for the security. In the context of IPOs, this prohibition generally is discussed in terms of attempts to induce aftermarket bids or purchases while the distribution is still occurring. Attempts to induce aftermarket bids or purchases can give prospective IPO purchasers the impression that there is a scarcity of offered securities and the balance of their buying interest therefore can only be satisfied in the aftermarket.⁵¹

⁴⁷ Issuer’s management who own shares may be similarly incentivized to underprice the IPO in order to realize a profit from an aftermarket price “pop” or to demonstrate the purported strength of the issuer.

⁴⁸ The NYSE/NASD IPO Advisory Committee Report, *supra* note 7, discusses several abusive allocation practices, such as spinning and laddering, that were subsequently prohibited under FINRA rules. The term “spinning” refers to the practice by which an underwriter allocates IPO shares to directors or executives of investment banking clients in exchange for receipt of investment banking business. The term “laddering” refers to the practice of inducing investors to give orders to purchase shares in the aftermarket at particular prices (thereby providing price support in the aftermarket) in exchange for receiving IPO allocations. Other harmful practices identified by the report that were seen to give rise to public concern include unlawful *quid pro quo* arrangements in which underwriters unlawfully allocate IPO shares based on a potential investor’s agreement to pay excessive commissions on trades of unrelated securities. See also X. Liu and J.R. Ritter, *The Economic Consequences of IPO Spinning*, Review of Financial Studies 23, 2024-2059 (2010).

⁴⁹ A number of Commission and FINRA or New York Stock Exchange actions have concerned conduct in connection with IPOs. See, e.g., *SEC v. J.P. Morgan Securities, Inc.*, Litigation Release No. 18385 (Oct. 1, 2003) (consenting to a final judgment that ordered a civil penalty and permanently enjoined J.P. Morgan from violating Rule 101 and NASD Conduct Rule 2110); *SEC v. Morgan Stanley & Co. Incorporated*, Litigation Release No. 19050 (Jan. 25, 2005) (consenting to a final judgment that ordered a civil penalty and permanently enjoined Morgan Stanley from violating Rule 101 of Regulation M); *SEC v. Goldman Sachs & Co.*, Litigation Release No. 19051 (Jan. 25, 2005) (consenting to a final judgment that ordered a civil penalty and permanently enjoined Goldman Sachs from violating Rule 101 of Regulation M); NASD News Release, “NASD Charges Robertson Stephens with Sharing in Millions of Dollars of Customers’ Profits in Exchange for “Hot” IPO Shares,” (Jan. 9, 2003) (announcing that Robertson Stephens was censured and ordered to pay a civil penalty for receiving inflated commissions from more than 100 client accounts in exchange for the allocation of hot IPOs); NASD News Release, “NASD Regulation Charges Credit Suisse First Boston with Siphoning Tens of Millions of Dollars of Customers’ Profits in Exchange for “Hot” IPO Shares,” (Jan. 22, 2002) (announcing that NASD censured Credit Suisse First Boston and directed it to pay a civil penalty for taking inflated commissions in exchange for allocations of hot IPOs).

⁵⁰ 17 CFR 242.100 *et seq.* Regulation M, among other things, prohibits issuers, selling security holders, underwriters, broker-dealers, and other distribution participants from directly or indirectly bidding for, purchasing, or attempting to induce any person to bid for or purchase any security that is the subject of the distribution during certain restricted periods.

⁵¹ See Regulation M Guidance. See also *Report of the Special Study of the Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 88-95, pt. 1 at 520-21, 556 (1 Sess. 1963); and *Report of the Securities and Exchange Commission Concerning the Hot Issues Markets*, at 37-38 (August 1984).

In addition, FINRA Rule 5131 is designed to address conflicts of interest in the pricing of IPOs and promote transparency in IPO pricing so that issuers can make informed decisions regarding the IPO price. Many of the provisions of Rule 5131 stemmed from a report in 2003 by the New York Stock Exchange (NYSE)/National Association of Securities Dealers (NASD) IPO Advisory Committee.⁵² Specifically, the rule requires that the lead underwriter provide to the issuer's pricing committee (or to the board of directors if there is no pricing committee) a regular report of the names of the institutional investors that have given indications of interest, the amount of shares the investor is interested in, an aggregate report of retail interest, and a report after the offering indicating the final allocation of shares. Rule 5131 also addresses abusive allocation practices, including spinning, laddering and other *quid pro quo* arrangements, that could encourage underwriters to underprice an IPO.

FINRA Rule 5121 places restrictions on public offerings where an underwriter has a conflict of interest, which generally includes circumstances where the underwriter stands to gain from the offering beyond underwriting compensation (for example, all or a portion of the proceeds of the offering will be paid to an underwriter, such as to repay loans extended to the issuer by an affiliate of the underwriter). Rule 5121 requires, among other things, disclosure of the conflict in the prospectus and, in some cases, the use of an underwriter that does not have a conflict, referred to as a "qualified independent underwriter" to participate in the preparation of the disclosure materials, exercising the usual standards of due diligence.⁵³

3. Did the exercise of pricing discretion in the Facebook IPO harm retail investors?

As noted above, I cannot comment on a specific registrant or transaction.

4. Please provide a summary of internal or external research the Commission has relied on with regard to IPO overpricing and underpricing throughout the past 20 years. I would like to know if the research provides a perspective on who benefits and who suffers harm from the potential mispricing of IPOs.

Many studies have been conducted regarding IPO pricing, and a number of these have focused on the benefits and costs to all participants in the IPO market.⁵⁴ One article that provides

⁵² See NYSE/NASD IPO Advisory Committee Report, *supra* note 7. As noted in footnote 30, *supra*, I served in a number of senior positions at FINRA and its predecessor, the NASD. I represented the NASD on the NYSE/NASD IPO Advisory Committee.

⁵³ In 2009, Rule 5121 was amended to eliminate a requirement that the qualified independent underwriter must render an opinion that the public offering price is no higher than that recommended by the qualified independent underwriter. Commentators expressed strong support for eliminating this requirement. See *Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Modernize and Simplify NASD Rule 2720*, Release No. 34-60113 (June 15, 2009).

⁵⁴ See, e.g., K. Rock, *supra* note 44 (some investors are better informed than others and so can avoid participating in overvalued IPOs; however larger allocations in overvalued IPOs received by uninformed investors has to be countered by deliberate underpricing.); L.M. Benveniste and P. A. Spindt, *supra* note 4 (underpricing compensates better-informed investors for truthfully revealing their information before the issue price is finalized); and I. Welch,

a good summary of this literature is *A Review of IPO Activity, Pricing, and Allocations* by Jay Ritter and Ivo Welch.⁵⁵ In addition, many economists currently in the Commission's Division of Risk, Strategy, and Financial Innovation have researched and written on IPOs,⁵⁶ and actively work to contribute to, and maintain familiarity with, the latest academic work.

As described above, a number of academics do not view underpricing as "mispricing" or error, but, rather, as a response to other factors, such as a desire to attract institutional and long-term investors and a concern about liability that could arise from poor aftermarket performance.

5. Do the vast majority of IPO shares go to institutional investors? Please provide summary data on the allocation of IPO shares generally over the past 20 years to institutional investors and other classes of privileged investors and ordinary investors.

While I understand it is widely believed that institutional and other large investors comprise a large portion of the allocation for many IPOs, the Commission has not collected allocation information in connection with offerings and does not have access to allocation data maintained by offering participants. There is little publicly available evidence on institutional allocation outside of what is reported in one research paper, which covered 174 issues during the period 1997-1998, and found that institutional investors are favored over retail investors in IPO

supra note 16 (issuer is better informed about its own true value, leading to an equilibrium in which higher-valued firms use underpricing as a signal);

⁵⁵ J.R. Ritter and I. Welch, *supra* note 14.

⁵⁶ See, e.g., K.W. Hanley and G. Hoberg, *Litigation Risk, Strategic Disclosure and the Underpricing of Initial Public Offerings*, *Journal of Financial Economics* 103, 235-254 (2012); C. Caglio, K.W. Hanley and J. Marietta-Westberg, *Going Public Abroad*, Working paper, available at SSRN (2011) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572949; C.N.V. Krishnan, V. Ivanov, R.W. Masulis and A.K. Sing, *Venture Capital Reputation, Post-IPO Performance, and Corporate Governance*, *Journal of Financial and Quantitative Analysis* 46, 1295-1333 (2011); K.W. Hanley and G. Hoberg, *supra* note 44; A.K. Edwards and K.W. Hanley, *Short Selling in Initial Public Offerings*, *Journal of Financial Economics* 98, 21-39 (2010); W. Johnson and J. Marietta-Westberg, *The Distribution of IPO Holdings Across Institutional Mutual Funds*, *Journal of Business Ethics* 90, 119-128 (2009); V. Ivanov and C.M. Lewis, *The Determinants of Market-wide Issue Cycles for Initial Public Offerings*, *Journal of Corporate Finance* 14, 567-583 (2008); P.K. Chaney and C.M. Lewis, *Income Smoothing and Underperformance in Initial Public Offerings*, *Journal of Corporate Finance* 4, 1-29 (1998); W.C. Johnson and J. Marietta-Westberg, *Universal Banking, Asset Management, and Stock Underwriting*, *European Financial Management* 15, 703-732 (2009); T. Loughran and J. Marietta-Westberg, *Divergence of Opinion Surrounding Extreme Events*, *European Financial Management* 11, 579-601 (2005); K.W. Hanley, C.M.C. Lee and P.J. Seguin, *The Marketing of Closed-End Funds: Evidence From Transactions Data*, *Journal of Financial Intermediation* 5, 127-159 (1996); K.W. Hanley and W.J. Wilhelm, *supra* note 8; K.W. Hanley, *The Underpricing of Initial Public Offerings and the Partial Adjustment Phenomenon*, *Journal of Financial Economics* 34, 231-250 (1993); K.W. Hanley, A.A. Kumar and P.J. Seguin, *Price Stabilization in the Market for New Issues*, *Journal of Financial Economics* 34, 177-197 (1993); K.W. Hanley and J.R. Ritter, *Going Public*, *The New Palgrave Dictionary of Money and Finance*, ed. J. Eatwell, M. Milgate and P. Newman, London: The Stockton Press, 248-255 (1992); W.L. Megginson and K. Weiss, *Venture Capitalist Certification in Initial Public Offerings*, *Journal of Finance* 46, 879-903 (1991) (Reprinted in *Venture Capital*, Mike Wright, Lowell W. Busenitz and Harry J. Sapienza eds., (Edward Elgar, 2003)); K. Weiss, *The Post-Offering Price Performance of Closed-End Funds*, *Financial Management* 18, 57-67 (1989) (Securities and Exchange Commission Released Papers, July 21, 1989).

allocations.⁵⁷ One other study, based on 38 firm commitment, U.S. IPOs underwritten by a leading underwriter over the period 1983-1988, also found that institutional investors are favored over retail investors in IPO allocations.⁵⁸

6. Do communications restrictions within the Securities Act inhibit price discovery in the IPO process?

The communications rules applicable to IPOs permit a company, along with an underwriter, to use a variety of different methods, from traditional book-building to pricing methods based on auction models, to determine the appropriate price for the company's securities in its IPO, while at the same time ensuring that all investors considering purchasing securities in the IPO have access to consistent information about the company, the securities being offered, and the offering itself. Taken in this context, I do not believe these rules unduly inhibit price discovery in the IPO process.

From the perspective of investors, the communications restrictions are intended to provide widely-available, reliable, and comprehensive information about the company and the offering. The rules applicable to communications in an IPO are designed to ensure that the prospectus remains the primary document that contains extensive disclosure and financial information about the company, but, at the same time, permit companies and underwriters to supplement the prospectus with additional information as long it is filed with the Commission and subject to the same review and consideration as the prospectus. This process also ensures that all investors have access to this information.

The restrictions do not limit the ability of the underwriters to perform due diligence about the company, or the ability of management of the company to make road show presentations to prospective investors or to meet one-on-one with investors. The restrictions also do not limit the ability of research analysts to meet with the company to gather information needed for review and analysis. In addition, because oral offers are permitted after a registration statement is filed, underwriters are able to engage in discussions with potential investors as described above in order to understand the depth of investor interest in the offering.

7. Does the SEC recognize that the "quiet period" rules and legal liability under Rule 175 provide institutional investors with an informational advantage over ordinary investors?

As discussed above, the quiet period rules and liability provisions under the federal securities laws help to provide all investors with access to comprehensive and reliable information that can be used to make an investment decision. Issuers and offering participants

⁵⁷ R. Aggarwal, N. Prabhala and M. Puri, *supra* note 8.

⁵⁸ K.W. Hanley and W.J. Wilhelm, *supra* note 8. Other research shows that institutional investors also are favored in Europe. See A.P. Ljungqvist and W.J. Wilhelm, *IPO Allocations: discriminatory or discretionary?*, *Journal of Financial Economics* 65 (2), 167-201 (2002).

are free to include forward-looking information and projections in the prospectus and in free writing prospectuses, and Rule 175 provides a safe harbor to issuers for forward-looking information included in the prospectus. Notwithstanding the availability of a safe harbor under Rule 175 (and, for follow-on offerings, Securities Act Section 27A), it is my understanding that companies rarely include projections or earnings guidance in the prospectus. Additionally, I understand that underwriters rarely prepare their own offering materials that are filed as free writing prospectuses, which may be the result of the absence of a safe harbor. Also, Rule 175 itself does not impose liability; instead, the rule creates a limited safe harbor for issuers against liability arising under Securities Act Sections 11, 12(a)(2), and 17(a) and Exchange Act Section 10(b) and Rule 10b-5. Therefore, Rule 175 can be asserted by an issuer as a defense to claims arising under these sections.

Underwriters and other offering participants are subject to the same level of liability for oral communications with investors, including institutional investors, as they are for written communications, which would include the prospectus to which many ordinary investors would be limited. Written offers, including free writing prospectuses, and oral offers are subject to liability under Securities Act Section 12(a)(2).

8. Does the SEC agree that the quiet period is more and more difficult to enforce given advances in communications and information technology? Please comment on the costs and benefits of enforcing communications restrictions given current technology.

I agree that the Commission's rules must keep pace with innovations in technology and methods of communication in order to properly balance our mission to protect investors, facilitate capital formation, and maintain fair and orderly markets. As communications technology changes, and, importantly, the manner in which companies and investors communicate changes, we need to continue to assess the effectiveness of our rules. The costs and benefits of the regulatory structure governing communications during offerings should be considered as a part of that review.

In relaxing the communications rules in 2005, the Commission sought to recognize the integral role that technology plays in timely informing the market and investors about important corporate information and developments.⁵⁹ In adopting these reforms, the Commission acknowledged that modern communications technology, including the internet, provides a powerful, versatile, and cost-effective medium to communicate quickly and broadly. Accordingly, current rules contemplate and accommodate the use of modern technology to communicate with investors. These rules also encourage electronic and web-based solutions for the delivery of information to investors, such as the introduction of an "access-equals-delivery" model and the use of hyperlinks in written offers to meet the "accompanied or preceded by a prospectus" standard.

⁵⁹ See Securities Offering Reform Release ("The tremendous growth in communications technology are resulting in more information being provided to the market on a more non-discriminatory, current, and ongoing basis.").

Staff in the Commission's Division of Corporation Finance is aware of the challenges companies face in dealing with intensive media and investor interest in their offerings and the number of ways communications may take place. I understand that the staff does not seek to micromanage communications during the offering process, and instead, takes a pragmatic approach to these communications.

9. Please explain how restricting ordinary investors' access to marketing materials from an issuer protects ordinary investors. Is the quiet period intended to protect ordinary investors from themselves? In other words, is "puffing" or misleading investors with exaggerated marketing the Commission's primary concern?

As described above, the IPO communications rules are designed to ensure that the prospectus remains the primary disclosure document. I believe this approach provides real benefits to the offering process by assuring that comprehensive information about the company provided to Commission staff for review is widely and readily available to all investors. I also recognize that the communications rules need to be flexible enough so that companies and underwriters can respond to dynamic markets. As I described above, I believe that the Commission has provided significant flexibility – and a number of different options – for companies and underwriters to communicate with potential investors. I also believe, however, that we should review our communications rules and the application of the quiet period in light of the changes in both the way the market functions and the changes in communications technology that have occurred since our last major reform in 2005.

10. Does the Commission expect that "puffing" of an issuer would likely be offset by differing views that can be quickly and efficiently publicized in internet articles, blogs and other forms of modern communication?

I understand that many investors are self-directed, online investors who do not expect to rely exclusively on research and analysis performed by financial professionals or the advice of financial advisors. For many of these investors, I expect that information that is publicly filed by the issuer and subject to securities law liability remains a critical part of the information they use to form an investment decision.

Although the vast majority of the disclosures provided, and statements made, by companies are comprehensive and consistent with applicable requirements, the media and other forms of modern communication can be a very useful check on the disclosures and other statements made by companies conducting an IPO. The staff responsible for reviewing IPO registration statements and other filings regularly reviews these publications, which include traditional media sources and new forms of financial markets coverage available on the internet, for new and different perspectives. The review process benefits greatly from information provided by these sources. Additionally, the staff can benefit from tips and complaints from individuals who see the pending filing. While the staff's review benefits from third-party information, its review of registration statements cannot rely solely on third parties to challenge statements made by companies. In addition, as a practical matter, although the IPOs of some companies are widely followed in the media, a significant number of companies going public, especially smaller companies, are not the subject of in-depth reporting and public debate.

11. Does the Commission believe the elimination of the up-tick rule, the prevalence of hedge funds and other proprietary traders that seek to short overvalued shares, and other changes to the marketplace largely eliminate concerns related to “puffing”?

Changes in market participants, trading strategies, or the functioning of exchanges do not eliminate the benefits of balanced and reliable disclosure, most particularly in the context of an IPO where there is limited historical financial or operating information available about the company. Market participants’ ability to engage in legitimate short selling, in compliance with applicable regulations, can provide benefits, such as market liquidity and pricing efficiency (once a trading market has been established).⁶⁰ At the same time, the Commission has noted that unrestricted short selling – including potentially manipulative or abusive short selling – could be used to exacerbate a price decline in a security and may harm investor confidence. For instance, to address concerns about short selling being used as a tool to drive down the price of a security that has already experienced significant intra-day price declines, the Commission adopted a new short sale price test restriction in February 2010.⁶¹ This rule is an updated and more narrowly tailored version of the former “uptick rule,” which, as noted in your letter, the Commission eliminated in 2007.

Specifically, in Rule 201 of Regulation SHO the Commission adopted a short sale-related circuit breaker that, if triggered, imposes a restriction on the prices at which a security may be sold short for the remainder of the day and the following trading day. The rule’s circuit breaker-based approach, which is used to target securities that are experiencing significant intra-day price declines, differs from the former uptick rule’s broader application to all short sales in exchange-listed securities. The Commission determined to adopt a circuit breaker approach in Rule 201, rather than a permanent, market-wide short sale price test, to limit impediments to the normal operations of the market while still achieving the goals of a short sale price test restriction.

In addition, the Commission staff has stated that Rule 201’s short sale price test restriction does not apply on a security’s first day of trading pursuant to a new security offering, such as an IPO.⁶² This is because the short sale-related circuit breaker is only triggered when there is a decline of 10% or more from a security’s closing price on the prior day. Since there is no prior day’s closing price on the first day of trading, the short sale price test restriction cannot potentially be triggered until the second day of trading, at the earliest.

As discussed further in response to Question 34 below, short sale activity does not typically occur until the opening of trading (*i.e.* after the registration statement is effective and pricing has occurred). Therefore, it would not likely have an impact on an issuer’s communications during the period before the registration statement is effective. While it is

⁶⁰ See, e.g., *Amendments to Regulation SHO*, Release No. 34-61595 (February 26, 2010).

⁶¹ See Rule 201 of Regulation SHO.

⁶² Division of Trading and Markets: Responses to Frequently Asked Questions Concerning Rule 201 of Regulation SHO, FAQ 3.2, available at <http://www.sec.gov/divisions/marketreg/rule201faq.htm>.

possible that the potential for short selling that could affect the aftermarket performance of the company's stock following an IPO, which could impact the success of future offerings, could serve as a disincentive for issuers to make misleading statements in connection with the offering or otherwise attempt to condition the market in advance of the offering, the securities laws liability provisions provide a more direct disincentive for that activity. One study has shown that short sales in IPOs begin as early as the open of the initial trading day and that there is greater short selling activity in IPOs with higher underpricing.⁶³ There is no evidence, however, that short selling in IPOs mitigates the aftermarket effects of IPO underpricing.

- 12. Do analysts that work within research departments of broker-dealers suffer potential liability under Rule 175(a) if their analysis fails to accurately predict the performance of an IPO issuer?**

I have included the response to this question with the response to Question 13.

- 13. Does the Commission believe it is reasonable to expect that analysts' estimates are accurate ex-post, and is it reasonable that any liability should be associated with something as unrealistic as predicting the future?**

As noted in response to Question 7, Rule 175 itself does not impose liability. Instead, the rule creates a limited safe harbor for issuers against liability arising under Securities Act Sections 11, 12(a)(2), and 17(a) and Exchange Act Section 10(b) and Rule 10b-5.

In general, research reports released by analysts that are employed by a broker-dealer participating in an IPO are subject to the anti-fraud provisions of the federal securities laws. This liability would not extend, however, to the simple failure of an analyst to accurately predict the future performance of an issuer.⁶⁴

- 14. Do subjective requirements for a reasonable basis and good faith open the door to needless and excessive litigation, and acts to prevent ordinary investors from receiving valuable information?**

The heightened pleading requirements under the Private Securities Litigation Reform Act of 1995⁶⁵ make it less likely that a plaintiff could even bring a claim that would otherwise be defeated by a Rule 175 defense. Nevertheless, the efficacy of the Rule 175 safe harbor has been a subject of longstanding debate, and it has been observed that Rule 175 has been relied upon

⁶³ See, e.g., A.K. Edwards and K.W. Hanley, *Short Selling in Initial Public Offerings*, *Journal of Financial Economics* 98 (1), 21-39 (2010).

⁶⁴ See *Safe Harbor for Forward-Looking Statements*, Release No. 33-7101 (Oct. 13 1994). See also H. Beck, *The Substantive Limits of Liability for Inaccurate Predictions* (March 23, 2006), available at <http://law.bepress.com/expresso/eps/1182>. See generally *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988); *Aaron v. SEC*, 446 U.S. 680, 689-697 (1980); *McConville v. SEC*, 465 F.3d 780, 786 (7th Cir. 2006); and *SEC v. Fehn*, 97 F.3d 1276, 1289 (9th Cir. 9th Cir. 1996).

⁶⁵ Pub. L. 104-67, 109 Stat. 737 (1995) (PSLRA).

infrequently. In a 1994 concept release addressing the adequacy of then-existing safe harbors, the Commission noted that:

[t]he safe harbor is infrequently raised by defendants, perhaps because it compels judicial examination of reasonableness and good faith, which raises factual issues that often preclude early, pre-discovery dismissal. Thus, critics state that the safe harbor is ineffective in ensuring the quick and inexpensive dismissal of frivolous private lawsuits.⁶⁶

There have been approximately ten cases exploring the substance of the Rule 175 requirements since the rule was adopted in 1978. As a result, there is little evidence to assess whether the requirement that a plaintiff show that a statement was made without reasonable basis and other than in good faith has resulted in excessive litigation. Moreover, although these standards have a factual element, there have been instances where defendants have successfully dismissed lawsuits for failure to state a claim on the basis of Rule 175.⁶⁷

15. **Does the Commission believe that, under Section 27A, these same analysts can provide earnings estimates for publicly traded companies without being subject to legal liability if, ex-post, their earnings fail to meet the estimates? Please explain the substantive basis for treating analysis of an IPO issuer differently than the analysis of a public company.**

As discussed in response to Question 13, there is, as a general matter, no liability under the federal securities laws based solely on the failure of an analyst to accurately estimate the future earnings of an issuer. Moreover, anti-fraud provisions do not treat an analyst's analysis of a public company differently than an analyst's analysis of an IPO company or a private company; the elements of the fraud claim are the same.

The existing statutory or rule-based safe harbors do not reference research analysts or communications made by research analysts.⁶⁸ Section 27A of the Securities Act, which was enacted by Congress in 1995, applies to forward-looking statements made by (1) an issuer that, at the time the statements are made, is subject to the reporting requirements of the Exchange Act; (2) a person acting on behalf of such issuer; (3) an outside reviewer retained by such issuer making a statement on behalf of such issuer; or (4) an underwriter, with respect to information provided by such issuer or information derived from information provided by the issuer. Section 27A does not reference research analysts or the reports of research analysts. In considering Section 27A, some have suggested that it may be possible to characterize a research analyst as an

⁶⁶ See *Safe Harbor for Forward Looking Statements*, *supra* note 64.

⁶⁷ See, e.g., *Roots P'ship v. Lands' End*, 965 F.2d 1411, 1417-18 (7th Cir.1992); *Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1446 (5th Cir. 1993); and *Katz v. Household Intern'l, Inc.* 91 F.3f 1036, 1040 (7th Cir. 1996).

⁶⁸ Among other potential defenses, the "bespeaks caution" doctrine, which is a judicially created rule that accepts certain cautionary language attached to forward-looking statements as a defense to securities fraud liability, has been applied to analyst statements in securities litigation brought against research analysts. See R.J. Colombo, *Buy, Sell, or Hold? Analyst Fraud from Economic and Natural Law Perspectives*, 73 Brooklyn Law Review 91, 109-110 (2007) (citing *In re Salomon Analyst AT&T Litig.*, 350 F. Supp. 455, 467 (S.D.N.Y. 2004)).

“underwriter” within the scope of the safe harbor, making a research analyst’s reports forward-looking statements with respect to information provided by such issuer or information derived from information provided by the issuer, within the scope of Section 27A.⁶⁹

In addition, your letter also raises a question as to whether Rule 175 applies to research reports. The Rule 175 safe harbor is only available for forward-looking statements made by or on behalf of the issuer, or by an outside reviewer retained by the issuer, that are made in or reaffirmed in a document filed with the Commission, such as an issuer’s quarterly or annual report or, in the case of an IPO, in the issuer’s registration statement.⁷⁰ For Rule 175 to apply to a research report, the research report or other statement made by a research analyst would have to be considered a statement “made by or on behalf of the issuer or by an outside reviewer retained by the issuer.”

16. Consistent with Section 27A of the Securities Act, would the Commission consider modifying Rule 175 to provide a broad safe harbor with regard to forward looking information relating to an issuer? Specifically, would you revise Rule 175a to eliminate the subjective aspects of that subsection?

In connection with the 2005 offering reforms discussed above, the Commission requested comment on whether to propose a safe harbor similar to Section 27A for companies conducting an IPO for the use of projections and forward-looking information. Although at the time a few commentators supported extending the safe harbor to IPOs, particularly for forward-looking information that is required to be disclosed, commentators generally were concerned that, because of the relatively untested nature of companies engaging in IPOs, there was limited basis for investors to assess the reasonableness of assumptions underlying projections about the issuer’s business.⁷¹ The Commission did not adopt a safe harbor at that time. There is a question, however, as to whether companies would include projections in a prospectus if the safe harbor was extended to an IPO. I understand that more seasoned companies, which would fall within the scope of Section 27A protections, typically do not include earnings estimates and other projections in their filings, particularly those related to a securities offering. Additionally, because Rule 175 is only available with respect to information included in, or reaffirmed in, a filing with the Commission, the elimination of the subjective aspects of the rule may not address the concerns raised in your letter regarding the scope of permissible communications.

As background, the requirements for good faith and reasonableness pre-date Rule 175, and were first established in the 1970s when the Division of Corporation Finance issued

⁶⁹ R.J. Colombo, *supra* note 68.

⁷⁰ Securities Act Rule 175.

⁷¹ See Securities Offering Reform Release. See also comment letter from the Committee on Federal Regulation of Securities of the American Bar Association Section of Business Law (Feb. 11, 2005) (urging the Commission to create a safe harbor for forward-looking information for IPOs, similar to the Section 27A safe harbor for other types of offerings, but noting the belief that such a safe harbor would be used only rarely to include projections in offers), available at <http://www.sec.gov/rules/proposed/s73804/dljohnson021105.pdf>.

disclosure guidance for the use of projections in filings.⁷² With respect to the reasonable basis requirement the guidance noted: “The [Division of Corporation Finance] believes that management should have the option to present in Commission filings its good faith assessment of a company’s future performance. Management must, however, have a reasonable basis for such an assessment. A history of operations or experience in projecting may be among the factors providing a basis for management’s assessment.”⁷³

Rule 175 only comes into play once a company asserts it as a defense. At that point, the burden shifts to the plaintiff to prove that the statements were not reasonable or made in good faith. Only if the plaintiff can overcome that burden can it negate the defense – but that still leaves any other potential defenses to securities fraud liability (for example, materiality or lack of scienter) available to the defendant.

17. Is it the Commission’s interpretation that research relating to Emerging Growth Companies will still be subject to Rule 175? Does this mean that, even in the case of these relatively smaller companies that seek to go public, retail investors will suffer the same informational disadvantage?

As described above, there is no limitation (other than anti-fraud prohibitions) on the ability of a broker-dealer that is not an offering participant in the IPO to publish research about an IPO issuer. Section 105(a) of the JOBS Act enables a broker-dealer that is participating, or will participate, in an IPO for an emerging growth company to publish research reports about the emerging growth company.⁷⁴ The JOBS Act did not, however, eliminate potential liability under the general anti-fraud provisions, nor did the JOBS Act extend the Rule 175 safe harbor to research reports. Therefore, offering participants that publish research reports relating to emerging growth companies would still be subject to Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5. As discussed above, this is the same treatment afforded to research reports by broker-dealers that are not participating in the offering, as well as for broker-dealers that continue research coverage of already-public companies under Rule 139. The research reports published on emerging growth companies, as with all research reports, would not have the benefit of the safe harbor provided by Section 175.

Approximately 90% of the IPO issuers in 2011 would have been considered emerging growth companies had the JOBS Act provisions been in place at that time, which means that

⁷² See Notice of Adoption of an Amendment to Rule 14a-9 and Withdrawal of the Other Proposals Contained in Release No. 33-5581, Release No. 33-5699 (April 23, 1976) (stating that the SEC would no longer “object to the disclosure in filings with the Commission of projections which are made in good faith and have a reasonable basis, provided that they are . . . accompanied by information adequate for investors to make their own judgments.”).

⁷³ *Id.* at 7.

⁷⁴ JOBS Act Section 105 amends Section 2(a)(3) of the Securities Act to provide that such a research report is not a prospectus under Section 2(a)(10) and is not an offer for sale or an offer to sell a security for purposes of Section 5(c). A broker dealer participating in the IPO of an emerging growth company would not be subject to Section 12(a)(2) liability for the research report, but would still be subject to the general anti-fraud provisions of the federal securities laws.

emerging growth company status and the resulting flexibility provided by Title I of the JOBS Act is expected to have broad impact. Nevertheless, it is not known whether broker-dealers will take advantage of the JOBS Act changes allowing offering participants to publish research during an offering for an emerging growth company. To date, we have not observed this practice in the IPOs that have been completed in the few months since the JOBS Act became effective.

18. Does the Commission believe expanding access to research for retail investors could enhance information dissemination, attract additional investors and lower the cost of capital for these smaller companies?

Broader and more open access to research for retail investors could enhance the information made available to retail investors, which could encourage retail investment. As explained above, however, there are no rules that limit the ability for retail investors to have access to analyst research, nor are there rules that would mandate a broker-dealer to widely disseminate their proprietary research. Research reports are typically made available by a broker-dealer to its clients (whether institutional or retail). Alternatively, investors can subscribe for access to research reports supplied by third-party research aggregators.

Although expanded access to research could benefit investors and issuers, it should not be considered a substitute for the information in the prospectus and registration statement. It is still important for investors to review the offering documents prepared by the company in order to reach their own opinion of the company and the offering.

19. Given that limited access and a higher cost of capital disproportionately affects smaller issuers, would the Commission consider addressing the informational disadvantage to retail investors by modifying Rule 175 at least in the case of Emerging Growth Companies? (If you are unwilling to modify Rule 175 generally).

As discussed in the response to Question 16, the Commission did, in 2005, consider a broader communications safe harbor for companies conducting an IPO. The Commission has not proposed or otherwise requested comment on whether to provide a safe harbor from liability for research reports. Although the JOBS Act expands the ability of offering participants to disseminate research in connection with the IPO of an emerging growth company, it did not alter the current liability framework for statements made in these research reports. As discussed in response to Questions 13 and 15, analysts generally would not face liability solely for making inaccurate predictions, and, furthermore, analysts may rely on the “bespeaks caution” doctrine, among other defenses, to potential securities fraud claims.

20. Given the direction of law and regulation under Section 105, isn't it time to recognize that the quiet period rules no longer provide substantive benefits to the marketplace and are also inconsistent with the Supreme Court's recent interpretation of the First Amendment?

As explained in response to Question 21 below, I believe that the quiet period rules continue to provide substantive benefits to the marketplace and are not inconsistent with the First Amendment.

21. **How does the Commission reconcile the quiet period rules, which effectively restrict an issuer's communications to ordinary investors, with the Supreme Court's decision in *Lorillard* where the Supreme Court applied a four part test, developed in *Central Hudson*, and applied in *Lorillard*. The four prong test states "the Court must determine (1) whether the expression is protected by the First Amendment, (2) whether the asserted governmental interest is substantial, (3) whether the regulation directly advances the governmental interest asserted, and (4) whether it is not more extensive than necessary to serve the government's interest." *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 527 (2001).**

Your first letter asked for a reconciliation of the quiet period rules with the Supreme Court's decision in *Lorillard Tobacco Co. v. Reilly*.⁷⁵ In *Lorillard*, the Court invalidated state regulations governing the advertising of smokeless tobacco and cigars. The Court found that prohibitions on outdoor advertising within a 1,000 foot radius of any public playground, playground area in a public park, elementary school or secondary school were "more extensive than necessary to advance the State's substantial interest in preventing underage tobacco use."⁷⁶ The Court also found that prohibitions on indoor advertising placed lower than five feet from the floor of any retail establishment within a 1,000 foot radius of those areas did "not seem to advance" the goal of preventing underage tobacco use and did "not constitute a reasonable fit with that goal."⁷⁷ In my view, the quiet period rules do not appear to suffer from the same defects.

Lorillard evaluated the advertising restrictions under the four part test for analyzing regulations of commercial speech set forth in *Central Hudson Gas & Elec. Corp. v. Public Serv. Comm'n of New York*, 447 U.S. 557, 563-64 (1980).⁷⁸ Under that test, for commercial speech to fall within the protection of the First Amendment:

...it must at least concern lawful activity and not be misleading. Next, we ask whether the asserted governmental interest is substantial. If both inquiries yield positive answers, we must determine whether the regulation directly advances the governmental interest asserted, and whether it is not more extensive than is necessary to serve that interest.⁷⁹

Communications regarding registered offerings are not inherently unlawful or inherently misleading. Nor can there be any doubt that the government interest is substantial. "The primary purpose of the Securities Act is to protect investors by requiring publication of material information thought necessary to allow them to make informed investment decisions concerning

⁷⁵ *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 527 (2001).

⁷⁶ *Id.* at 565.

⁷⁷ *Id.* at 566-67.

⁷⁸ *Id.* at 554.

⁷⁹ *Id.*

public offerings of securities in interstate commerce.”⁸⁰ “Congress intended for Section 5 to protect the public from misleading, fraudulent, illusory, or incomplete statements made by issuers or underwriters, who, in their efforts to persuade investors to participate in a financing, might fail to disclose material information.”⁸¹ Section 5 ensures that investors “have access to, and an opportunity to consider, the disclosures of the material business and financial facts of the issuer provided in registration statements and prospectuses.”⁸²

A restriction on commercial speech directly advances a substantial government interest if it will alleviate the harms that the government seeks to prevent to a material degree.⁸³ Although the Court in *Lorillard* found that the restrictions on advertising placed lower than five feet from the floor of a retail establishment did not advance the interest in preventing minors from using tobacco products because “[n]ot all children are less than 5 feet tall, and those who are certainly have the ability to look up and take in their surroundings,” the Court also found that the restrictions on outdoor advertising did in fact advance that interest.⁸⁴ Notably, the Court found that restrictions on advertising advanced the state’s interest in preventing underage use of tobacco products despite the existence of laws prohibiting the sale of tobacco products to minors. The Court “acknowledged the theory that product advertising stimulates demand for products, while suppressed advertising may have the opposite effect.”⁸⁵ The quiet period rules restrict the communications that “encourage[] [investors] to form a premature opinion of value without benefit of the full set of facts contained in a prospectus.”⁸⁶ The rules’ premise is that “if investors could receive glossy, promotional literature from the issuer, they might pay little attention to the dull, formalistic prospectus prepared in accordance with the rules of a government agency.”⁸⁷ The quiet period rules thus protect investors by “forc[ing] the company to market its securities principally by means of the disclosure document prepared in accordance with the SEC’s rules and subjected to prior review by the SEC’s staff.”⁸⁸ Additionally, requiring a company to use a registration statement and prospectus as the means by which it markets its offering to potential investors subjects those efforts to Securities Act liabilities.

As noted above, finding that the limitation on communications during the quiet period directly advances the substantial government interest in ensuring that potential investors who

⁸⁰ *Pinter v. Dahl*, 486 U.S. 622, 638 (1988).

⁸¹ J. A. Brill, Note, “Testing the Waters”—*The SEC’s Feet Go from Cold to Wet*, 83 Cornell L. Rev. 464, 476 (1998), citing S. Rep. No. 83-1036, at 2 (1954); S. Rep. No. 73-47, at 1-2 (1933); H.R. Rep. No. 73-85, at 1-5 (1933).

⁸² *Carl M. Loeb, Rhoades & Co.*, 38 S.E.C. 843, 849 (1959).

⁸³ *Lorillard*, 533 U.S. at 555.

⁸⁴ *Id.* at 557-61, 566.

⁸⁵ *Id.* at 557.

⁸⁶ *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 426 F.2d 569, 575 (2d Cir. 1975).

⁸⁷ J. C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration*, 52 Washington & Lee Law Review 1143, 1151 (1995).

⁸⁸ *Id.*

receive offers for securities receive the information that accompanies registration is not sufficient for it to withstand First Amendment scrutiny, as the limitation must also be narrowly tailored to be not more extensive than necessary. Although in *Lorillard* the Court ultimately invalidated the outdoor advertising restrictions as insufficiently narrowly tailored because their effect would be to “constitute nearly a complete ban on the communication of truthful information about smokeless tobacco and cigars to adult consumers,”⁸⁹ the quiet period rules do not operate so broadly. The Commission and its staff have taken steps over the years to facilitate communications around public offerings, and a number of accommodations have been made. Indeed, as described above, in 2005 the Commission engaged in a comprehensive overhaul of the regulation of public offerings and eased a number of the restrictions then in place.⁹⁰ Moreover, the limitations on communications during the quiet period are of finite duration, thus ensuring that the impact on speech is limited.

The Commission will continue to consider the First Amendment interests implicated by the quiet period, but those interests must be assessed in light of the Securities Act provisions that require investors who receive offers for securities to also receive the information that accompanies registration, as well as protection against misleading communications.

22. The “ban on general solicitation” relates to marketing investments for private offerings that ordinary investors typically cannot access; and therefore these ordinary investors do not suffer direct harm. However, as seen in the case of the Facebook IPO, and the stunted communications resulting from the S-1 Registration Statement process, the “quiet period” communications restrictions do harm ordinary investors. Please assert the Commission’s substantial interest that justifies this harm.

As explained in the response to Question 21 above, I believe the Commission has a substantial interest in protecting investors by ensuring that potential investors receive offers for securities that are accompanied by the information registration provides, and that such information is unaccompanied by statements from issuers or underwriters who, in their efforts to persuade investors to participate in a financing, might fail to disclose material information.

23. Given the Commission’s reliance on market price for the accounting of financial assets and liabilities and via event studies for the measurement of damages, it is clear the Commission considers market price as the best determinant of fair market value. Please provide an explanation as to why the Commission considers market price as the best determination of market value and contrast this to the non-market approach applied to traditional IPOs.

The Commission has not articulated a position as to what it considers to be the best determination of market value in connection with an IPO.

⁸⁹ *Lorillard*, 533 U.S. at 562; see also *Lorillard* at 561-66.

⁹⁰ See Securities Offering Reform Release (adopting rules that “seek to recognize the integral role that technology plays in timely informing the markets and investors about important corporate information and developments).

A reliable estimate of an asset's fair market valuation is generally the price at which the asset most recently traded. The most recent price becomes less reliable as a measure of the fair market value as more time passes since the last trade. While the Commission relies on market prices to establish fair market values in certain circumstances, the soundness of these methods depends on the presence of active trading markets. Prior to an IPO, there is generally not an active trading market for an issuer's securities.

Your letter suggests a "Dutch auction" approach as a market-based approach for establishing an offering price. In the form of modified Dutch auction generally used in IPOs, valuations by bidders are not based on observable market prices. The process generates a number of bid prices prior to the public trading of the company's stock that are determined by potential investors based on their own valuations of the company relying on information provided by the company. In contrast, as discussed above, traditional IPOs use an underwriter to establish one bid price through the book-building process with potential investors that are also relying on information provided by the company.

24. If, using market prices and changes to market prices within an event study, the Commission can deem a price to be artificial, does the Commission view material price changes that immediately follow an IPO as evidence of artificial prices? In other words, doesn't the common post-IPO "pop" in a share price reflect artificial underpricing?

I have included the response to this question with the response to Question 25.

25. Does the common post-IPO "pop" reflect positively or negatively on the efficiency of the securities markets?

As discussed above, there is not a consensus that a post-IPO pop reflects underpricing that can, in the ordinary course, be described as "artificial." There is broad theoretical literature that has offered a number of different explanations for underpricing. In particular, this research shows that without planned underpricing, institutional and other informed investors would have less incentive to provide accurate valuation or pricing information during the book-building process, and otherwise have an incentive to provide a valuation estimate designed to generate a lower offer price, which would effectively yield a similar first day gain. Therefore, as this theory articulates, the company and its underwriters would have less price-relevant information, which would increase valuation uncertainty and the likelihood of pricing error in advance of trading. I do note that, as discussed above and consistent with the views of others, underpricing may benefit underwriters and their clients with the value derived from the subsequent stock price increase resulting from the underpricing.

26. Does the Commission have the authority or the ability to impose a market-based IPO price determination process without legislation?

The Commission does not have the authority to impose a market-based IPO price determination process (or any other IPO price determination process) absent legislation.

- 27. Does the Commission believe that market-based IPO pricing would result in more accurate pricing, or a fairer market valuation, when compared to the type of IPO process that was applied in the Facebook issuance?**

I have included the response to this question with the response to Question 28.

- 28. Would a market-based auction model, such as a Dutch auction, eliminate the pricing discretion exercised by the underwriter and issuer?**

As described above, even in connection with a modified Dutch auction, the company along with the underwriter exercises significant discretion in setting the price in an IPO. In modified Dutch auctions, companies typically reserve the ability to set the final offering price lower than the clearing price obtained in the auction by taking into account a number of other factors, including, among other things, general market trends, operating results, and the expected stability of the trading price following the offering.

- 29. Does the Commission believe in the principle where, if an auction is opened up to all investors, access to information regarding the issuer should be expanded as well?**

The federal securities laws require that certain basic information be disclosed in connection with an IPO, regardless of the type of underwriting arrangements entered into by the issuer, the way in which the offer is priced, or the type of potential investors (*i.e.* retail or institutional investors). The information required to be disclosed is intended to enable investors to make informed investment decisions. This applies to offerings irrespective of whether the offering is conducted as an auction.

- 30. Does the Commission recognize that the use of Form S-1 Registration Statements to update the public is a burdensome, slow and expensive process that hampers information dissemination that would enable a greater understanding of an issuer's value?**

As described above, under current rules, the company and underwriters are able to update the disclosure in an IPO using a variety of methods, depending on the type of information being communicated. Importantly, the Commission's rules do not require companies to re-circulate printed copies of a revised prospectus when updates or amendments are made to information previously provided to investors. Instead, investors have access to a filing when it has been electronically filed on EDGAR, whereupon it becomes publicly available in real-time. Whether an update is needed and the method by which any updates are made is determined by the company. A company usually makes this decision based on the facts and circumstances at the time. Although I do not believe that the current process relating to updating information in a prospectus restricts communication between a company and its investors, I recognize the importance of assessing our rules in this area in light of changing technology and offering practices.

- 31. Would the Commission recommend to Congress the complete abandonment of the “non-market-based approach” provided for under the 1933 Act and, instead, require a market based approach, such as a Dutch auction that the issuer opens to all market participants? Please explain why or why not.**

In 2003, the NASD and NYSE convened a committee at the Commission’s request to review the IPO underwriting process, particularly price setting and allocation practices, and to recommend to the securities industry such changes as may be necessary to address problems that had been observed during the technology bubble.⁹¹ In its report, the committee explored the Dutch auction process as an alternative to traditional allocation and pricing methods. Notably, the committee concluded that “the market, and not regulators, should determine whether book-building, a Dutch auction or another method is desirable for a particular IPO.”⁹² I believe that this continues to be an appropriate approach, and I would not recommend the abandonment of the current legislative and regulatory framework for IPOs, which allows the company to determine the best method to raise capital through the public markets.

- 32. Does the Commission believe that, if the ability to sell shares short applied directly to the setting of a market clear price within a Dutch auction process, then this would help to ensure accurate pricing by enabling sophisticated short-sellers to reduce the potential that puffing causes an artificially high price?**

I have included the response to this question with the response to Question 34.

- 33. Would the Commission consider allowing for short sales to be incorporated when calculating the market clearing price in a Dutch auction for IPO shares?**

I have included the response to this question with the response to Question 34.

- 34. Please provide the Committee with information on whether allowing short sales within the Dutch auction could act to eliminate concerns for “puffing” by opening up the IPO to a broader set of initial investors/traders.**

Prior to secondary market trading, there is no formalized way to short a future new issuance in the United States (*i.e.* there is no “when issued” market).⁹³ Once secondary market trading begins for a company following an IPO, evidence shows that an active short market begins immediately upon the first trade in an IPO.⁹⁴ As such, there is already a mechanism in place for market participants to sell shares they were not otherwise allocated in the IPO.

⁹¹ See NASD/NYSE IPO Advisory Committee Report, *supra* note 7. As noted above, I participated on this committee.

⁹² *Id.*

⁹³ Such a market does exist in Germany. See W. Aussenegg, P. Pichler and A. Stomper, *IPO Pricing with Bookbuilding and a When-Issued Market*, *Journal of Financial and Quantitative Analysis*, 41, 829-862 (2006).

⁹⁴ See A. K. Edwards and K.W. Hanley, *Short Selling in Initial Public Offerings*, *Journal of Financial Economics* 98, 21-39 (2010).

It is not clear how a short selling provision could be implemented within a Dutch auction. The clearing price in a Dutch auction is based on a solicitation of buying interest, in the form of bids, and not selling interest. To incorporate selling interest would require a different auction design. As with conventional modified Dutch auctions, any such design would need to comply with Section 5 of the Securities Act, such that short sales (or unconditional indications of selling interest) would not be permitted until after the registration statement is declared effective. Further, it is not clear why someone would consider a short sale (or even an indication of selling interest) before the offering price is set, given the significant uncertainty involved, not only as to what the offering price will be, but also as to whether the IPO will price at all and when. In addition, to the extent that someone believes the price will fall in the aftermarket, there is little incentive for such a person to facilitate the setting of a lower initial offering price, which would reduce such person's ability to gain from a future price drop.

* * * *

Please call me at (202) 551-2100 or have your staff call Tim Henseler, Acting Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2015 if you have any questions or comments.

Sincerely,



Mary L. Schapiro
Chairman