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Regulation M Amendments and Effect on Offerings

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March 14, 2024

Agenda

- Overview of Regulation M and Refresher on Rules 101 and 102
- SEC's Latest Amendments to Regulation M
- Reg M's New Record-Keeping Obligations and FINRA Reporting Obligations
- Impact on Broker-Dealers and Related Considerations
- Practical Considerations and Related Market Developments

Regulation M Overview and Rules 101 and 102

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Regulation M

- Intended to limit the activities of certain participants in a distribution, which activities may have a manipulative effect on the market for the offered security. For instance, activities that could:
  - artificially raise the price of a security
  - create a false appearance of active trading in the market by investors
- Roadmap/Questions to ask:
  - Is my transaction a distribution under Reg M?
  - What is the covered security?
  - How long is the trading restriction? When does the restricted period start and end?
  - What is the activity being restricted?
  - Is there an exception (*e.g.* excepted security or excepted activity) I can rely on?

Is Regulation M applicable to your transaction?

- Is the transaction a “distribution” for Regulation M purposes
  - A distribution means an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods
- Regulation M does not define magnitude nor does it define special selling efforts

Assessing magnitude

- Factors to consider in assessing the magnitude of an offering:
  - The number of shares to be sold in the proposed distribution
  - The number of shares to be sold in the proposed distribution as a percentage of the company's pre-transaction total shares outstanding
  - The offering's size by comparison to the company's public float
  - The average daily (and weekly) trading volume of the security
  - How does the size of the offering compare to the Rule 144 volume threshold?
  - How does the size of the offering compare to the definition of a "block" under 10b-18?

Special selling efforts

- Actions that may evidence or constitute special selling efforts:
  - An agreement that "provides for unusual transaction-based compensation" compared to compensation that would be expected for typical broker or dealer activity; consider, for example, whether the compensation structure and sales efforts increase a distribution participant's incentive to manipulate the market in order to facilitate the offering
  - Conducting road shows (management presentations)
  - Conducting outgoing investor calls
  - Preparing and delivering offering documents, including a prospectus or an offering memorandum
  - Soliciting the exercise or conversion of warrants or convertible securities
  - Placing outgoing calls to investors as compared to responding to incoming calls or reverse inquiries from investors or being aware of interest in the security due to a broker's activities as a market maker in the security
  - Whether the broker-dealer's sales force is engaged in the process
  - Making public announcements related to a possible offering

What transactions may involve Reg M distributions?

- A private placement
- A PIPE transaction
- A block trade or a series of block trades
- An at-the-market offering
- A shelf takedown
- A merger transaction
- An exchange offer

Additional Factors to consider in assessing whether an offering is a distribution

- Consider whether
  - The proposed offering involves sales of the issuer's securities or sales of the securities of an affiliate
  - The offering is made pursuant to a registration statement
  - The offering is underwritten
  - The securities will be sold on a reverse inquiry basis
  - The volume of the securities to be offered is significant relative to the issuer's total shares outstanding

Which security is subject to Regulation M requirements?

- Covered security: the security that is the subject of the distribution (the subject security) as well as any reference security

- A “reference security” means a security into which the subject security may be converted, exchanged or exercised

What is the relevant period? When does the restricted period begin and end?

- Restricted period is the period during which the trading prohibitions established by Reg M apply. Participants must determine the relevant restricted period.
- The restricted period *begins*:
  - One day before pricing: for any security with an ADTV of $100,000 or more of an issuer the common equity securities of which have a public float of $25 million or more
  - Five days before pricing: for all other securities
- Restricted period *ends* on participant's completion of participation in distribution.
- For a distribution involving a merger, acquisition, or exchange offer, the period *begins* on the day proxy solicitation or offering materials are first disseminated to security holders and *ends* upon the completion of the distribution, which is the end of the period in which holders can vote or exchange.

When is the underwriter's participation in a distribution deemed completed?

- When the underwriter's participation (or allocation) has been distributed
- Usually at pricing, the underwriters will give an all-sold notice
- Some difficult offerings (often referred to as "sticky deals") may not be fully sold at pricing.
  - Should the underwriters keep the syndicate together and continue the offering?
  - Or should the underwriters take the unsold securities (the "unsold allotment") into inventory and hold the securities in an investment account (the "freezer account") for a period of time to evidence their investment intent?
- The underwriters will want to consider carefully the alternatives and consult with legal and compliance

Rule 101

- Prohibits a distribution participant or an affiliated person to directly or indirectly bid for, purchase, or attempt to induce any person to bid for or purchase a covered security during the restricted period
- Rule 101 does not apply to certain securities:
  - Actively-traded securities, provided the securities are not issued by the distribution participant or an affiliate
  - **Investment grade nonconvertible debt, nonconvertible preferred and asset-backed securities***
  - Exempted securities
  - Face amount securities

**Old rule; replaced by amendments effective August 21, 2023*

Rule 101 *(cont'd)*

- Rule 101 does not apply to certain activities:
  - Research reports subject to Rule 138 or Rule 139
  - Stabilizing transactions made in compliance with Rule 103 or Rule 104
  - Odd-lot transactions
  - Exercises of securities (per terms of options, warrants, convertible securities)
  - Unsolicited brokerage transactions
  - Basket transactions
  - De minimis transactions
  - Offers to sell the securities being distributed
  - Transactions in Rule 144A securities

Rule 102

- Rule 102 prohibits an issuer or selling securityholder from directly or indirectly bidding for, purchasing or attempting to induce any person to bid for or purchase a covered security during the restricted period
  - If an affiliated purchaser is a distribution participant, the affiliated participant can comply with Rule 101 instead of Rule 102
- Rule 102 does not apply to certain securities:
  - **Investment grade nonconvertible debt, nonconvertible preferred and asset-backed securities***
  - Exempted securities
  - Face amount securities

**Old rule; replaced by amendments effective August 21, 2023*

Rule 102 *(cont'd)*

- Rule 102 does not apply to certain activities:
  - Odd-lot transactions
  - Tenders by closed-end funds
  - Redemptions by commodity pools
  - Exercises of securities
  - Unsolicited purchases
  - Offers to sell the securities being distributed
  - Transactions in Rule 144A securities

Recent Amendments to Regulation M

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Amendments to Regulation M ("Final Rules")

- Adopted by the SEC on June 7, 2023
- Background: After 2008 crisis, Congress enacted Dodd-Frank Act which directed the SEC to review its rules and remove references to or reliance on credit ratings
  - Regulation M is an anti-manipulation measure, intended to limit activities of participants in a distribution, that may have a manipulative effect on the market for the offered security
- Final Rules:
  - remove references to credit ratings in Regulation M
  - replace them with alternative measures of creditworthiness
  - impose related record-keeping obligations on broker-dealers
- Took effect on August 21, 2023

Replacement of Investment Grade Securities Exceptions in Rules 101 and 102

- General Rule: Prohibits underwriters, broker-dealers, distribution participants (Rule 101), and issuers, selling securityholders (Rule 102), from bidding for or purchasing a covered security during specified restricted period
- Exceptions: Excepted Activities and Excepted *Securities* listed in Rules 101 and 102

***Old* Exceptions for Investment Grade Securities**	***New* Exceptions based on Alternative Standards of Creditworthiness depending on Type of Security**
Nonconvertible debt and nonconvertible preferred securities with an **investment grade rating**	Nonconvertible debt and nonconvertible preferred securities for which **issuer's probability of default**, estimated as of 6th business day before pricing and over 12 months thereafter, is 0.055% or less, using a structural credit risk model
Asset-backed securities with an **investment grade rating**	Asset-backed securities **offered under** an effective shelf registration statement filed on **Form SF-3**

Exceptions for Nonconvertible debt and nonconvertible preferred securities

- SEC rationale for old exceptions: investment grade securities are largely fungible and trade primarily on the basis of yield and creditworthiness, rather than identity of issuer, hence less likely to be subject to manipulation
- New standard for nonconvertible securities now based on Probability of Default
  - issuer's probability of default, estimated as of the sixth business day before pricing and over 12 months thereafter should be 0.055% or less
  - "structural credit risk model": any commercially or publicly available model that calculates, *based on an issuer's balance sheet*, the probability that the issuer's value may fall below the threshold at which it would fail to make scheduled debt payments, at or by the expiration of a defined period
- Lead manager of a distribution (or a person acting in a similar capacity) must make and document in writing, the probability of default determination
  - May perform analysis internally or employ third-party vendors or commercial data providers to do so or assist it

Exceptions for asset-backed securities

- New exceptions for asset-backed securities that are offered under an effective shelf registration statement filed on Form SF-3
- Per SEC, the eligibility and transaction requirements of Form SF-3 allow for shelf offerings of only those ABS that share the same qualities as investment grade ABS
  - For instance, investors in registered ABS deals focus on the class structure of securities and nature of assets pooled to serve as collateral
  - Form SF-3 eligibility is limited by the percentage of delinquent assets
  - There is a focus on the collateral's ability to generate cash flows to service debt
  - Because of the pool's asset quality, registered ABS securities should trade based on yield and creditworthiness, similar to existing investment grade ABS
- No record-keeping requirement for asset-backed securities exceptions, only applies to new exceptions for nonconvertible debt and preferred securities

Reg M's new record-keeping obligations

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Record-Keeping Requirement for Probability of Default Determination

- Final Rules amend Rule 17a-4(b) under the Securities Exchange Act of 1934, which is the SEC's broker-dealer record retention rule
- Pursuant to new SEC Rule 17a-4(b)(17), broker-dealers are required to keep written records of the probability of default determination relied upon by them in connection with the distribution
  - Must retain written probability of default estimate for a period of at least three years, with the first two years in an easily accessible place
  - If the broker-dealer was the lead manager in a distribution, it could satisfy the rule by retaining the written determination it made
    - Document the value of each variable used in credit risk model and source of such information
    - Maintain documentation of assumptions used in vendor model and output of vendor
  - If the broker-dealer was not the lead manager, it could obtain from the lead manager a copy of the written probability of default estimate or retain a written notice it received from the lead manager regarding the probability of default determination

Notice Requirements under FINRA Rule 5190

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Notice Requirements under FINRA Rule 5190

- FINRA Rule 5190 sets forth notification requirements applicable to distributions of *listed and unlisted securities* that are "covered securities" *subject to a restricted period* under Rule 101 or 102 of Regulation M
  - Notices under FINRA Rule 5190 provide FINRA with pertinent distribution-related information in a timely fashion to facilitate FINRA's regulatory activities with respect to its Regulation M compliance program
  - All notices under FINRA Rule 5190 must be submitted to FINRA's Market Regulation Department electronically through the FINRA Firm Gateway or a third-party vendor (*e.g.*, Dealogic, Ipreo)
  - FINRA Rule 5190 incorporates by reference the definitions of certain terms as set forth in Rule 100 of Regulation M
- Specifically, pursuant to FINRA Rule 5190(c)(1), firms must determine (in accordance with Regulation M) whether the applicable restricted period commences one day or five days prior to pricing, and notify FINRA in writing of the firm's determination and the basis for such determination
  - As a practical matter, FINRA will accept a firm's notification that the five-day restricted period applies to a prospective distribution without providing the basis for that determination
  - However, if a firm asserts that a one-day or no restricted period applies (*e.g.*, the "actively traded securities" exception applies), the firm is required to demonstrate the basis for that determination

Notice Requirements under FINRA Rule 5190 *(cont.)*

- The written notification must include the contemplated date and time of commencement of the restricted period and identify the distribution participants and any affiliated purchasers
- Firms must provide this written notification to FINRA no later than the business day prior to the first complete trading session of the applicable restricted period, unless later notification is necessary under specific circumstances
  - FINRA expects firms to provide notification within the prescribed time frame, although FINRA's Market Regulation Department may permit later notification on a case-by-case basis
  - FINRA recognizes that there may be instances where the nature of the transaction has made it impossible to provide timely notice (*e.g.*, a PIPE offering is commenced and priced on the same day)
- In addition, firms must notify FINRA upon pricing a distribution that is subject to a restricted period under Regulation M, which notice must be submitted to FINRA no later than the close of business the next business day following the pricing of the distribution

Notice Requirements under FINRA Rule 5190 *(cont.)*

- FINRA Rule 5190(c)(2) requires that *any firm that is an issuer or selling security holder* in a distribution of a security (including an "actively traded" security) subject to a restricted period under Rule 102 of Regulation M comply with the notification requirements of FINRA Rule 5190(c)(1)
- With respect to *distributions of "actively traded" securities*, FINRA Rule 5190(d) requires that a firm notify FINRA in writing of the firm's determination that no restricted period applies and the basis for such determination
  - Firms must notify FINRA no later than the close of business the next business day following the pricing of the distribution, unless later notification is necessary under specific circumstances
  - Firms must notify FINRA upon pricing a distribution of a security that is considered "actively traded" no later than the close of business the next business day following the pricing of the distribution, unless later notification is necessary under specific circumstances

Notice Requirements under FINRA Rule 5190 *(cont.)*

- FINRA Rule 5190(e) requires firms to notify FINRA of *penalty bids or syndicate covering transactions* in connection with an offering of an OTC Equity Security (which, as defined in FINRA Rule 6420(f), includes all non-exchange-listed equity securities)
  - Firms must notify FINRA of their intention to conduct such activity prior to imposing the penalty bid or engaging in the first syndicate covering transaction, and identify the security and its symbol and the date such activity will occur
  - Firms also must subsequently confirm such activity within one business day of completion, and identify the security and its symbol, the total number of shares and the date(s) of such activity
- Firms must update any notification submitted to FINRA pursuant to FINRA Rule 5190, as necessary (*e.g.*, a manager must update the notification if distribution participants were added after the restricted period commenced or if a deal was oversubscribed and the over-allotment option was exercised)

Notice Requirements under FINRA Rule 5190 *(cont.)*

- Responsibility for compliance with the notification requirements under FINRA Rule 5190(c)(1) and (d) lies with the firm acting as a manager (or in a similar capacity) of the distribution
  - If no firm is acting as a manger (or in a similar capacity), then each firm that is a distribution participant or affiliated purchaser is required to notify FINRA, unless another firm has assumed responsibility in writing for compliance with those requirements
- Pursuant to FINRA Rule 5190(c)(2), a firm that is an issuer or selling security holder must comply with the notification requirements of paragraph (c)(1) of the rule, unless another firm has assumed responsibility in writing for compliance with those requirements
- Similarly, pursuant to FINRA Rule 5190(e), a firm that intends to impose a penalty bid or effect a syndicate covering transaction is responsible for notifying FINRA, unless another firm has assumed responsibility in writing for compliance with the rule

Impact on Broker-dealers and Other Related Considerations

Enforcement Matters Relating to FINRA Rule 5190

- As part of FINRA's program to monitor for compliance with Regulation M, FINRA's Market Regulation Department reviews OTC trading and quoting activity for prohibited purchases, bids or attempts to induce bids or purchases during the applicable restricted period and for prohibited short sales during the five-day period prior to the pricing of an offering
- In August 2021, FINRA censured and fined a broker-dealer for violations of FINRA Rules 5190, 3110 and 2010 in connection with its participation in 34 distributions of securities in which it was late in filing, or failed to file, the notifications required under FINRA Rule 5190. FINRA noted that "[t]his matter arose from multiple surveillance alerts indicating that [the firm] failed to timely submit Regulation M-related notifications to FINRA" and certain national securities exchanges. The firm simultaneously resolved similar matters with various national securities exchanges. (Total fine of $85,000.)
- In September 2022, FINRA censured and fined a broker-dealer for violations of FINRA Rules 5190, 3110 and 2010 in relation to filing inaccurate, filing untimely, or failing to file approximately 205 required notifications to FINRA in connection with its participation as a manager in distributions of securities. The firm simultaneously resolved similar matters with various national securities exchanges. (Total fine of $500,000.)

FINRA Guidance on FINRA Rule 5190's Scope

- Pursuant to FINRA FAQs, "[t]he notice requirements of FINRA Rule 5190 apply to any offering of an *exchange-listed security* or an *OTC equity security*, as defined in [FINRA] Rule 6420"
  - As stated above, FINR Rule 6420(f) defines the term "OTC Equity Security" to include all non-exchange-listed equity securities
- Since the SEC's 2023 amendments to Regulation M, FINRA has not published any new guidance or updated existing guidance regarding FINRA Rule 5190's notification requirements
- Notwithstanding FINRA's guidance that FINRA Rule 5190's notice requirements apply only with respect to exchange-listed securities and OTC equity securities, we understand that most firms treat all SEC-registered and 3(a)(2) USD deals as potentially in scope, and, if the "probability of default" calculation is greater than 0.055%, these firms submit notices to FINRA pursuant to FINRA Rule 5190

Practical Considerations and Related Market Developments

Application to CP and ABCP

- Prior to the amendment, as A-1/P-1 and A-2/P-2 securities, CP and ABCP were excluded from the scope of Regulation M
  - "prime quality" requirement for Section 3(a)(3) CP
- After the amendment, we need to look closer:
  - "distribution" – unlikely the sale of CP or ABCP is a distribution due to the lack of special selling efforts and no unusual transaction-based compensation
  - "security" – Section 3(a)(10) definition excludes
    - currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited

Application to CP and ABCP *(cont'd)*

- The definition exempts Section 3(a)(3) CP and ABCP
  - Status of other short-term securities uncertain
- Transactions in Rule 144A securities are an excepted activity
- Does not exempt 3(a)(2) or 4(a)(2) CP or ABCP
- With same day settlement, very short restricted period
- Secondary market activity –
  - Should not be impacted
    - Different securities based on maturity and coupon
    - Unsolicited transactions

Practical Considerations *(cont'd)*

- Final Rules impact certain debt reopenings
  - Debt reopening: issuer sells additional securities that are fungible with an existing issue for US federal income tax purposes
  - If debt reopening is *SEC-registered* or relies on the *Section 3(a)(2)* exemption and lead managers previously relied on investment grade exception for Reg M purposes, then lead managers need to take additional steps
    - Adopt new procedures and processes, incur additional costs to make and document the probability of default estimate, use a structural credit risk model and preserve written records
  - If debt reopening is under *Rule 144A* or *Rule 144A/Reg S*, then can rely on existing exceptions for Rule 144A or Rule 144A/Reg S debt offerings in Rules 101 and 102

Practical Considerations *(cont'd)*

- Limited areas of application for fixed-income distributions
  - Rule 101 and 102 prohibitions do not apply unless the security being purchased is identical in all of its terms to the security being distributed
    - For Reg M purposes, an issuer's already outstanding debt securities are not considered to be the same as the debt security presently in distribution if there is even so much as a single day's difference in maturity or a single basis point difference in the coupon
  - Historically, investment grade exceptions in Rules 101 and 102 are relevant in limited circumstances including debt reopenings and "sticky" deals
    - Debt Reopenings
    - "Sticky" Deal: offering where a lack of demand results in an underwriter being unable to sell all of the securities in a distribution; underwriter continues to hold securities

Market developments

- August 28, 2023: SIFMA publishes update to SIFMA Master Agreement Among Underwriters (MAAU) model
  - Section 10.14 of SIFMA's Updated MAAU provides that each underwriter in every Offering of "Affected Nonconvertible Securities" authorizes the lead manager to act as the "Calculating Underwriter"
  - Calculating Underwriter will perform the probability of default estimate under the new Reg M exception and will be obliged to share that estimate (along with date of calculation, and model/vendor used) with the other broker-dealers
  - The definition of "Affected Nonconvertible Securities" is broad. It covers **all** nonconvertible debt or nonconvertible preferred securities --other than Rule 144A or Rule 144A/Reg S securities or 'Excepted Securities' under Rule 101 (except for actively-traded securities).

Market developments

- November 21, 2023: SIFMA note on *Reg M Amendments – Issuers and Guarantors with No Structural Credit Risk Models*
  - For certain classes of issuers of nonconvertible debt: there are no vendor-provided "structural credit risk model" (SCRM), or SCRM has no correlation to actual ratings
    - *Non-U.S. Sovereigns*. Schedule B filers that are highly-rated sovereigns or sovereign entities have traditionally relied on old investment grade exception.
      - But they cannot rely on new POD exception since SCRM definition measures POD based on an "issuer's balance sheet." Available vendor models (*e.g.*, Bloomberg sovereign risk model) focus on other factors (*e.g.,* real GDP per capital growth rate, inflation rate or political risk score). In many cases, available sovereign risk model fails/exceeds Reg M's 0.055% threshold (*e.g.*, Canada and US)
    - *Entities wholly-owned by non-US sovereigns or supranational entities with no US ownership interest.* (e.g., KfW Bankengruppe (Germany), Export Development Canada)
      - Cannot rely on "exempted securities" exception under Reg M for U.S. government securities or municipal bonds. No vendor provided SCRM for some issuers. For some issuers, the risk model defaults to the POD of the country that owns them – which leads to the same issues above.

Market developments

- November 21, 2023: SIFMA note on *Reg M Amendments (cont'd)*
  - For certain classes of issuers of nonconvertible debt: there are no vendor-provided "structural credit risk model" (SCRM), or SCRM has no correlation to actual ratings
    - *Certain non-profit issuers*. These are non-profit issuers (e.g. healthcare systems, hospitals, educational institutions) exempt from securities registration under Section 3(a)(4) of the Securities Act. Some are highly rated issuers that have traditionally relied on old investment grade exception.
      - Unlike government and municipal securities which are "exempted securities" under Rules 101 and 102 of Reg M, the securities issued by these non-profit issuers are not exempted securities under Reg M. In many cases, there are no available vendor SCRMs for their securities.
  - SIFMA believes all this was an unintentional outcome of recent Reg M amendments. SIFMA says it is interested in exploring possible exemptive relief with SEC staff.
    - SIFMA says a significant number of issuers (significantly higher than 24%) who were previously able to rely on the investment grade exception have failed to satisfy the 0.055% POD threshold. Says it may seek to further discuss the merits of this threshold with the staff.

Disclaimer

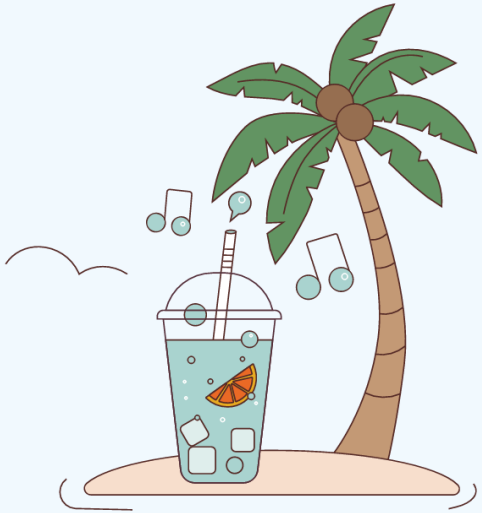
- These materials are provided by Mayer Brown and reflect information as of the date of presentation.
- The contents are intended to provide a general guide to the subject matter only and should not be treated as a substitute for specific advice concerning individual situations.

We welcome you to join us at our SIFMA celebration in Orlando.

On Monday evening at SIFMA, we'll be hosting an end-of-day gathering—Cuban food-truck cuisine, restorative libations, and a chance to mingle with your colleagues. See you there.

Click or scan here to RSVP

March 18, 2024
7:30—9:30 p.m. ET
Hilton Orlando Bonnet Creek



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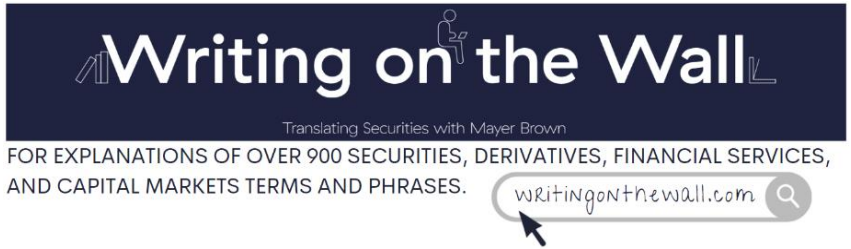
Resources



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