IDC Independent Directors Council
Promoting Excellence in Fund Governance

ICI Comments on SEC Proposal to Protect Investors During Securities Offerings, February 2005

February 15, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Regulation M (File No. S7-41-04)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposed amendments to Regulation M relating to anti-manipulation rules concerning the offering of securities.[2] The proposal is an important step in protecting investors from abuses in connection with securities offerings, particularly those made in initial public offerings ("IPOs").

An efficient securities offering process is critical to Institute members, who are significant investors in securities on behalf of millions of individual shareholders. The Institute therefore strongly supports the goals of the proposal – promoting integrity, fairness and transparency in the securities offering process – and believes that the proposal would provide investors with greater confidence when purchasing securities, especially in an IPO. One aspect of the proposed amendments, however, would have unintended consequences for closed-end investment companies as issuers. In particular, we believe the proposed amendment to Regulation M that would prohibit "penalty bids" would adversely impact the IPOs of closed-end funds.

Penalty bids are a means by which the managing underwriter of an offering may impose a financial penalty on syndicate members whose customers sell offering shares in the immediate aftermarket, i.e., "flip" the shares. Penalty bids are widely used by closed-end funds as a means to stabilize the market price of closed-end fund shares once aftermarket trading begins in the newly offered securities of the

fund. Our members report that widespread flipping of closed-end fund shares had been a significant problem until closed-end fund IPO syndicates began imposing such penalties. The use of penalty bids is therefore critical to the efficient public offering of closed-end funds.

The unique attributes and structural characteristics of closed-end funds differentiate such funds from operating companies and contribute to the importance of penalty bids. For example, in contrast to operating companies, the share price of closed-end funds frequently trade at a "discount" to the fund's net asset value shortly after the IPO, and that discount often persists in secondary market trading. By facilitating the stabilization of the market price of the closed-end fund offering through the reduction of flipping, penalty bids serve as an effective tool to protect the interests of the long-term shareholders of the fund by reducing the chances for this "market discount phenomenon." In addition, closed-end funds typically offer an unlimited number of shares to meet all public demand and, as newly created and capitalized entities, such funds do not have any operating history prior to their IPO. Consequently, there generally is not a significant appreciation of closed-end fund shares immediately after their issuance, thereby reducing concerns relating to "hot IPOs" of operating companies. Finally, closed-end funds issue their shares primarily, and in many cases exclusively, to retail investors, reducing any conflicts that could arise regarding the imposition of penalty bids on institutional and retail investors.

For these reasons, the Institute recommends that the Commission continue to permit closed-end funds to use penalty bids. One way to accomplish this would be for the Commission to adopt an approach similar to that proposed by the New York Stock Exchange and NASD.[3] These proposals would permit the use of penalty bids so long as the penalty is imposed on the entire syndicate in connection with sales to all participants in the IPO. As the SRO Release notes, this approach was supported by the NYSE/NASD IPO Advisory Committee, formed at the Commission's request to examine the IPO process.[4] In this manner, we believe the Commission can adequately address concerns regarding penalty bids (e.g., the inequitable imposition of such penalties) and achieve the goals of the amendments to Regulation M. Another way would be to create a narrow exception from the prohibition for closed-end funds.

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The Institute appreciates the opportunity to comment on the proposed amendments to Regulation M. Any questions regarding our comments may be directed to the undersigned at 202-371-5408, to Jane Heinrichs at 202-371-5410 or to Dorothy Donohue at 202-218-3563.

Sincerely,

Ari Burstein
Associate Counsel

cc: Annette L. Nazareth, Director
Robert L. D. Colby, Deputy Director

James Brigagliano, Assistant Director
Division of Market Regulation

Paul F. Roye, Director
Division of Investment Management
Securities and Exchange Commission

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry.

[2] SEC Release Nos. 33-8511; 34-50831; and IC-26691 (December 9, 2004), 69 FR 75774 (December 17, 2004).

[3] Securities Exchange Act Release No. 50896 (December 20, 2004), 69 FR 77804 (December 28, 2004) (“SRO Release”).

[4] NYSE/NASD IPO Advisory Committee, Report and Recommendations (May 2003).