

Barbara Z. Sweeney
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December 9, 2003

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-2003-140 - Proposed Rule Governing Allocations and Distributions of Shares in Initial Public Offerings Amendment No. 1**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find Amendment No. 1 to the above-numbered rule filing. Amendment No. 1 replaces the text of the initial rule filing in its entirety. NASD has not re-filed Exhibits 2 and 3, which remain unchanged. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the *Federal Register* release.

If you have any questions, please contact Joseph E. Price, Vice President, Corporate Financing Department, Regulatory Policy and Oversight, at (240) 386-4623; e-mail joseph.price@nasd.com or Gary L. Goldsholle, Associate General Counsel, NASD, Regulatory Policy and Oversight, at (202) 728-8104; e-mail gary.goldsholle@nasd.com. The fax number of the Corporate Financing Department is (240) 386-4654, and the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-2003-140
Consists of 27 Pages
December 9, 2003
Amendment No. 1

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”) and Rule 19b-4 thereunder, the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) proposed NASD Rule 2712 to further and more specifically prohibit certain abuses in the allocation and distribution of shares in initial public offerings (“IPOs”). Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are bracketed.

Rule 2712. IPO Allocations and Distributions

(a) Quid Pro Quo Allocations

No member or person associated with a member may offer or threaten to withhold shares it allocates in an initial public offering (“IPO”) as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the member.

(b) Spinning

No member or person associated with a member may allocate IPO shares to an executive officer or director of a company, or to the immediate family of such an executive officer or director:

(1) if the member has received compensation from the company for investment banking services in the past 12 months;

(2) if the member expects to receive or intends to seek compensation from the company for investment banking services in the next 3 months; or

(3) on the condition that such executive officer or director, on behalf of the company, direct future investment banking business to the member.

(c) Policies Concerning Flipping

(1) No member or person associated with a member may directly or indirectly recoup, or attempt to recoup, any portion of a commission or credit paid or awarded to an associated person for selling shares in an IPO that are subsequently flipped by a customer, unless the managing underwriter has assessed a penalty bid on the member.

(2) In addition to any obligation to maintain records relating to penalty bids under SEC Rule 17a-2(c)(1), a member shall promptly record and maintain information regarding any penalties or disincentives assessed on its associated persons in connection with a penalty bid.

(d) Definitions

For purposes of this Rule, the following terms shall have the meanings stated below.

(1) “Flipped” means the initial sale of IPO shares purchased in an offering within 30 days following the offering date of such offering.

(2) “Penalty bid” means an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.

(3) “Immediate family member” means a person’s parents, mother-in-law or father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-

law or daughter-in-law, and children, and any other individual to whom the person provides material support.

(4) “Material support” means directly or indirectly providing more than 25% of a person’s income in the prior calendar year. Members of the immediate family living in the same household are deemed to be providing each other with material support.

2. Procedures of the Self-Regulatory Organization

(a) At its meeting on July 24, 2002, the Board of Directors of NASD Regulation, Inc. approved publication of a Notice to Members requesting comment on new Rule 2712 and authorized the filing of the proposed rule change with the SEC. The NASD Board of Governors approved publication and authorized filing the proposed rule change with the SEC at its meeting on July 25, 2002. In August 2002, NASD issued Notice to Members 02-55.

Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt NASD Rules without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be no less than 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Joseph E. Price, Vice President, Corporate Financing Department, Regulatory Policy and Oversight, at (240) 386-4623 or Gary L. Goldsholle, Associate General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8104.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

NASD is proposing new Rule 2712, which will better ensure that members avoid unacceptable conduct when they engage in the allocation and distribution of IPOs. The proposed rule change also is intended to sustain public confidence in the IPO process, which is critical to the continued success of the capital markets.

NASD published for comment proposed new Rule 2712 in Notice to Members 02-55 (“NtM 02-55”). A discussion of the comment letters received by NASD is provided below.

In August 2002, shortly after NASD issued NtM 02-55, former SEC Chairman Harvey Pitt requested that NASD and the New York Stock Exchange (“NYSE”) convene a committee of experts to “review the IPO underwriting process, particularly price setting and allocation practices, in light of recent experience, and to recommend to the securities industry community such changes as may be necessary to address the problems that have been observed.”¹ In May 2003, the NYSE/NASD IPO Advisory Committee (“Advisory Committee”) issued its report and recommendations. In general, the Advisory Committee supported adoption of the rules proposed in NtM 02-55, although it suggested

¹ Letter to Richard Grasso, Chairman and CEO, NYSE, and Robert R. Glauber, Chairman and CEO, NASD, from Harvey L. Pitt, Chairman, SEC, dated August 22, 2002.

some modifications to the “spinning” provision. NASD has incorporated these suggestions into the proposed rule change. NASD intends to consider other recommendations of the Committee as the basis for possible rulemaking in the future.

Although NASD is proposing new rules addressing IPO allocations, the federal securities laws and existing NASD rules already prohibit IPO allocation abuses. In recent years NASD has brought several disciplinary actions with respect to violations of these provisions. These laws and rules would continue to apply, and will continue to be the subject of possible NASD enforcement, after the proposed rule change becomes effective. Moreover, each provision in proposed Rule 2712 would apply independently. Compliance with one provision would not provide a safe harbor with respect to the other provisions of the Rule or with respect to other federal securities law and existing NASD rules.

A. Prohibition of Abusive Allocation Arrangements

Rule 2712(a) would expressly prohibit a member and its associated persons from offering or threatening to withhold an IPO allocation as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the member. This provision would prohibit this activity not only with respect to trading services, but to any service offered by the member. In addition, trading activity that serves no economic purpose other than to generate compensation for the member (*e.g.*, wash sales) would be viewed as “excessive” in relation to the services provided by the member, which are meaningless.

NASD does not intend that this prohibition interfere with legitimate customer relationships. For example, this provision is not intended to prohibit a member from

allocating IPO shares to a customer because the customer has separately retained the member for other services, when the customer has not paid excessive compensation in relation to those services.

B. Prohibition of Spinning

“Spinning,” or awarding IPO shares to the executive officers and directors of an investment banking client, divides the loyalty of the agents of the company (i.e., the executive officers and directors) from the principal (i.e., the company) on whose behalf they must act. This practice is inconsistent with just and equitable principles of trade.

As proposed in NtM 02-55, Rule 2712(b) would have expressly prohibited a member and its associated persons from allocating IPO shares to an executive officer or director of a company on the condition that the executive officer or director, on behalf of the company, direct future investment banking business to the member. The rule also would have expressly prohibited IPO allocations to an executive officer or director as consideration for directing investment banking services previously rendered by the member to the company.

The NYSE/NASD IPO Advisory Committee supported the spinning proposal in NtM 02-55 with several modifications. First, the Advisory Committee recommended that NASD prohibit an allocation of IPO shares to immediate family members of an executive officer or director whenever an allocation to the officer or director would be prohibited. NASD has amended the proposed rule change to incorporate this recommendation. The definition of immediate family and a related definition, material support, are the same as in NASD Rule 2790, which was recently approved by the SEC.² Second, the Advisory Committee recommended that NASD bar IPO allocations to all executive officers and

² See 68 Fed. Reg. 62126 (October 31, 2003).

directors of a company with whom a member has an investment banking relationship. The Advisory Committee believed that the very existence of an investment banking relationship created, at the very least, an appearance of impropriety. NASD has amended the proposed rule change to incorporate this suggestion.

Consequently, proposed Rule 2712(b) would prohibit the allocation of IPO shares to an executive officer or director of a company, or to the immediate family of such an executive officer or director, if the member had received compensation from the company for investment banking services in the past 12 months. The Rule also would prohibit the allocation to these people if the member expects to receive or intends to seek compensation from the company for investment banking services in the next 3 months. The language of these provisions is based on similar language in NASD Rule 2711, concerning disclosure of investment banking compensation in research reports.

Under the proposed rule change, the accounts of executive officers and directors and their immediate family would, in effect, be restricted accounts similar to the accounts subject to the Free-Riding and Withholding Interpretation (IM-2110-1). Accordingly, NASD requests comment on whether the prohibition should be codified in Rule 2790, which was recently approved by the SEC³ and is slated to replace the Free-Riding and Withholding Interpretation.

In NtM 02-55, NASD proposed to amend Rule 2710, the Corporate Financing Rule, to require that members file information regarding the allocation of IPO shares to executive officers and directors of a company that hires a member to be the book-running managing underwriter of the company's IPO. This requirement was designed to assist the staff in monitoring the possibility that allocations were made in return for investment

³ Id.

banking business. Under the amended proposal, all allocations to executive officers or directors of investment banking clients or potential clients would be prohibited.

Accordingly, the proposed reporting requirement under Rule 2710 appears to be unnecessary and has been deleted from the proposal.

C. Restrictions on Penalty Bids

Rule 2712(c) would prohibit members from penalizing associated persons whose customers have "flipped" IPO shares that they have purchased through the member, unless a penalty bid, as defined in Rule 100 of SEC Regulation M has been imposed. Rule 100 defines a penalty bid as "an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions."

Rule 104 of Regulation M and Nasdaq Stock Market Rule 4624 provide notice and recordkeeping requirements for penalty bids. Penalty bids may be assessed in the aftermarket of an offering that is under downward price pressure from an imbalance of sell orders relative to purchase orders. NASD does not oppose this use of penalty bids. However, some members have penalized their registered representatives in connection with flipping by retail customers, even when the managing underwriter has not assessed a penalty bid on the syndicate members. For example, members have penalized their registered representatives by recouping the commission or credits previously granted for the sale of IPO shares.

The practical consequence of this practice is that registered representatives are penalized, and their retail customers may be pressured to retain their long position in the

IPO shares, while representatives for institutional customers generally are not penalized at all for flipping activity by their customers. The inequity of this selective penalization is most difficult to justify in light of the fact that most IPO shares are typically allocated to institutional customers. The proposed rule would effectively prohibit this selective practice by permitting members to assess internal penalties on their registered representatives only when the managing underwriter has imposed a penalty bid on the syndicate members. The provision would not place any limit on syndicate penalty bids, however. This proposal was supported by the IPO Advisory Committee.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which require, among other things, that NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the new, specifically targeted provisions in the proposed rule changes will aid member compliance efforts and help to maintain investor confidence in the capital markets.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

NASD requested written comments in NtM 02-55 and received four comment letters.⁴ All of the comment letters generally supported the proposal. The National Venture Capital Association, the Association for Investment Management and Research (“AIMR”) and the North American Securities Administrators Association, Inc. (“NASAA”) supported the amendments. NASAA noted that many of the prohibitions go to conduct that already is unlawful.

The Securities Industry Association (“SIA”) stated that “the new and specifically targeted provisions in Rule 2712 would aid member compliance efforts and help to maintain investor confidence in the capital markets.” The SIA supports proposed Rule 2712(a) but has concerns about how “excessive” compensation might be interpreted and suggests that the term be changed to “clearly excessive.” NASAA also noted that “excessive” compensation is not defined in the Rule and believes the term creates an exception that undermines the clarity of the provision. NASD believes that use of an “excessive” compensation standard takes into account all of the facts and circumstances surrounding the services provided. This flexibility would allow members and NASD to take into account the risk and effort involved in the transaction, usual and customary rates charged for similar services at broker/dealers in the same kind of business, and regional norms in setting prices for financial services.

As published in NtM 02-55, proposed Rule 2712 would have prohibited certain forms of aftermarket tie-in agreements. The SIA recommended that the language in the

⁴ National Venture Capital Association letter to Barbara Z. Sweeney (Sept. 9, 2002); the Association for Investment Management and Research letter to Barbara Z. Sweeney (Sept. 23, 2002); North American Securities Administrators Association, Inc. letter to Barbara Z. Sweeney (Sept. 23, 2002); and Securities Industry Association letter to Barbara Z. Sweeney (Sept. 24, 2002).

discussion section on aftermarket tie-ins “clarify that inquiries and discussions regarding a potential customer’s interest in purchasing and holding a security not be deemed solicitations for purposes of [the aftermarket tie-in provision].” AIMR believes the provision may be difficult to supervise or monitor and suggests that NASD “simply require heightened supervisory scrutiny of all IPO allocations and distributions.” NASD has determined not to pursue a proposed rule change addressing aftermarket tie-in arrangements at the present time.

The SIA supported the proposal to prohibit allocations to an executive officer or director as a condition or as consideration for investment banking business, but noted that it may be difficult to determine whether an allocation has been done as a condition or as consideration for investment banking business. The proposal as amended would bar IPO allocations to all executive officers and directors of a company with whom a member has an investment banking relationship.

As proposed in the NtM 02-55, the amendments to Rule 2710 would have required that a member file a statement with NASD regarding whether an executive officer or director participated in the selection of the book-running managing underwriter. The SIA noted that underwriters cannot know with certainty who participated in their selection or the significance of their roles. In addition, the SIA believes that the proposed requirement to file information under Rule 2710(b)(6)(A)(viii) with respect to the 180-day calendar period immediately following the effective date of an offering would be burdensome. As discussed above, NASD has modified the proposal to eliminate the proposed amendment to Rule 2710.

The SIA recommends that the time period specified in proposed Rule 2712(c)(2)(A) commence on the offering date instead of the effective date of an offering. The SIA notes that the offering date tracks the language used in the standard agreement among underwriters, which is used by member firms to track the period in which a penalty bid may be used. NASD has amended the proposal to make the change suggested by the SIA. Accordingly, the “offering date” for purposes of the rule is the date after pricing on which members first sell shares to the public.

As proposed in NtM 02-55, proposed Rule 2712 would have included a requirement that each member subject to the rule must adopt and implement written procedures reasonably designed to ensure that the member and its employees comply with the provisions of the rule. NASAA notes that members already are required to implement procedures to ensure compliance with NASD rules and the provision is unnecessary. NASD agrees that such procedures already are required by members and the provision has been deleted.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD, INC.

BY: _____
Barbara Z. Sweeney , Senior Vice President and
Corporate Secretary

Date: December 9, 2003

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- [leave space] ; File No. SR-NASD-2003-140)
[leave space for date]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in Initial Public Offerings (“IPOs”)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on [leave space] , the National Association of Securities Dealers, Inc. (“NASD”), filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is proposing NASD Rule 2712 to further and more specifically prohibit certain abuses in the allocation and distribution of shares in initial public offerings. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

Rule 2712. IPO Allocations and Distributions

(a) Quid Pro Quo Allocations

No member or person associated with a member may offer or threaten to withhold shares it allocates in an initial public offering (“IPO”) as consideration or inducement for

1 15 U.S.C. § 78s(b)(1).

2 17 CFR § 240.19b-4.

the receipt of compensation that is excessive in relation to the services provided by the member.

(b) Spinning

No member or person associated with a member may allocate IPO shares to an executive officer or director of a company, or to the immediate family of such an executive officer or director:

(1) if the member has received compensation from the company for investment banking services in the past 12 months;

(2) if the member expects to receive or intends to seek compensation from the company for investment banking services in the next 3 months; or

(3) on the condition that such executive officer or director, on behalf of the company, direct future investment banking business to the member.

(c) Policies Concerning Flipping

(1) No member or person associated with a member may directly or indirectly recoup, or attempt to recoup, any portion of a commission or credit paid or awarded to an associated person for selling shares in an IPO that are subsequently flipped by a customer, unless the managing underwriter has assessed a penalty bid on the member.

(2) In addition to any obligation to maintain records relating to penalty bids under SEC Rule 17a-2(c)(1), a member shall promptly record and maintain information regarding any penalties or disincentives assessed on its associated persons in connection with a penalty bid.

(d) Definitions

For purposes of this Rule, the following terms shall have the meanings stated below.

(1) “Flipped” means the initial sale of IPO shares purchased in an offering within 30 days following the offering date of such offering.

(2) “Penalty bid” means an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.

(3) “Immediate family member” means a person’s parents, mother-in-law or father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children, and any other individual to whom the person provides material support.

(4) “Material support” means directly or indirectly providing more than 25% of a person’s income in the prior calendar year. Members of the immediate family living in the same household are deemed to be providing each other with material support.

* * * * *

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

NASD is proposing new Rule 2712, which will better ensure that members avoid unacceptable conduct when they engage in the allocation and distribution of IPOs. The proposed rule change also is intended to sustain public confidence in the IPO process, which is critical to the continued success of the capital markets.

NASD published for comment proposed new Rule 2712 in Notice to Members 02-55 (“NtM 02-55”). A discussion of the comment letters received by NASD is provided below.

In August 2002, shortly after NASD issued NtM 02-55, former SEC Chairman Harvey Pitt requested that NASD and the New York Stock Exchange (“NYSE”) convene a committee of experts to “review the IPO underwriting process, particularly price setting and allocation practices, in light of recent experience, and to recommend to the securities industry community such changes as may be necessary to address the problems that have been observed.”² In May 2003, the NYSE/NASD IPO Advisory Committee (“Advisory Committee”) issued its report and recommendations. In general, the Advisory Committee supported adoption of the rules proposed in NtM 02-55, although it suggested some modifications to the “spinning” provision. NASD has incorporated these suggestions into the proposed rule change. NASD intends to consider other recommendations of the Committee as the basis for possible rulemaking in the future.

² Letter to Richard Grasso, Chairman and CEO, NYSE, and Robert R. Glauber, Chairman and CEO, NASD, from Harvey L. Pitt, Chairman, SEC, dated August 22, 2002.

Although NASD is proposing new rules addressing IPO allocations, the federal securities laws and existing NASD rules already prohibit IPO allocation abuses. In recent years NASD has brought several disciplinary actions with respect to violations of these provisions. These laws and rules would continue to apply, and will continue to be the subject of possible NASD enforcement, after the proposed rule change becomes effective. Moreover, each provision in proposed Rule 2712 would apply independently. Compliance with one provision would not provide a safe harbor with respect to the other provisions of the Rule or with respect to other federal securities law and existing NASD rules.

A. Prohibition of Abusive Allocation Arrangements

Rule 2712(a) would expressly prohibit a member and its associated persons from offering or threatening to withhold an IPO allocation as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the member. This provision would prohibit this activity not only with respect to trading services, but to any service offered by the member. In addition, trading activity that serves no economic purpose other than to generate compensation for the member (*e.g.*, wash sales) would be viewed as “excessive” in relation to the services provided by the member, which are meaningless.

NASD does not intend that this prohibition interfere with legitimate customer relationships. For example, this provision is not intended to prohibit a member from allocating IPO shares to a customer because the customer has separately retained the member for other services, when the customer has not paid excessive compensation in relation to those services.

B. Prohibition of Spinning

“Spinning,” or awarding IPO shares to the executive officers and directors of an investment banking client, divides the loyalty of the agents of the company (i.e., the executive officers and directors) from the principal (i.e., the company) on whose behalf they must act. This practice is inconsistent with just and equitable principles of trade.

As proposed in NtM 02-55, Rule 2712(b) would have expressly prohibited a member and its associated persons from allocating IPO shares to an executive officer or director of a company on the condition that the executive officer or director, on behalf of the company, direct future investment banking business to the member. The rule also would have expressly prohibited IPO allocations to an executive officer or director as consideration for directing investment banking services previously rendered by the member to the company.

The NYSE/NASD IPO Advisory Committee supported the spinning proposal in NtM 02-55 with several modifications. First, the Advisory Committee recommended that NASD prohibit an allocation of IPO shares to immediate family members of an executive officer or director whenever an allocation to the officer or director would be prohibited. NASD has amended the proposed rule change to incorporate this recommendation. The definition of immediate family and a related definition, material support, are the same as in NASD Rule 2790, which was recently approved by the SEC.³ Second, the Advisory Committee recommended that NASD bar IPO allocations to all executive officers and directors of a company with whom a member has an investment banking relationship. The Advisory Committee believed that the very existence of an investment banking

³ See 68 Fed. Reg. 62126 (October 21, 2003).

relationship created, at the very least, an appearance of impropriety. NASD has amended the proposed rule change to incorporate this suggestion.

Consequently, proposed Rule 2712(b) would prohibit the allocation of IPO shares to an executive officer or director of a company, or to the immediate family of such an executive officer or director, if the member had received compensation from the company for investment banking services in the past 12 months. The Rule also would prohibit the allocation to these people if the member expects to receive or intends to seek compensation from the company for investment banking services in the next 3 months. The language of these provisions is based on similar language in NASD Rule 2711, concerning disclosure of investment banking compensation in research reports.

Under the proposed rule change, the accounts of executive officers and directors and their immediate family would, in effect, be restricted accounts similar to the accounts subject to the Free-Riding and Withholding Interpretation (IM-2110-1). Accordingly, NASD requests comment on whether the prohibition should be codified in Rule 2790, which was recently approved by the SEC⁴ and is slated to replace the Free-Riding and Withholding Interpretation.

In NtM 02-55, NASD proposed to amend Rule 2710, the Corporate Financing Rule, to require that members file information regarding the allocation of IPO shares to executive officers and directors of a company that hires a member to be the book-running managing underwriter of the company's IPO. This requirement was designed to assist the staff in monitoring the possibility that allocations were made in return for investment banking business. Under the amended proposal, all allocations to executive officers or directors of investment banking clients or potential clients would be prohibited.

⁴ Id.

Accordingly, the proposed reporting requirement under Rule 2710 appears to be unnecessary and has been deleted from the proposal.

C. Restrictions on Penalty Bids

Rule 2712(c) would prohibit members from penalizing associated persons whose customers have "flipped" IPO shares that they have purchased through the member, unless a penalty bid, as defined in Rule 100 of SEC Regulation M has been imposed. Rule 100 defines a penalty bid as "an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions."

Rule 104 of Regulation M and Nasdaq Stock Market Rule 4624 provide notice and recordkeeping requirements for penalty bids. Penalty bids may be assessed in the aftermarket of an offering that is under downward price pressure from an imbalance of sell orders relative to purchase orders. NASD does not oppose this use of penalty bids. However, some members have penalized their registered representatives in connection with flipping by retail customers, even when the managing underwriter has not assessed a penalty bid on the syndicate members. For example, members have penalized their registered representatives by recouping the commission or credits previously granted for the sale of IPO shares.

The practical consequence of this practice is that registered representatives are penalized, and their retail customers may be pressured to retain their long position in the IPO shares, while representatives for institutional customers generally are not penalized at all for flipping activity by their customers. The inequity of this selective penalization

is most difficult to justify in light of the fact that most IPO shares are typically allocated to institutional customers. The proposed rule would effectively prohibit this selective practice by permitting members to assess internal penalties on their registered representatives only when the managing underwriter has imposed a penalty bid on the syndicate members. The provision would not place any limit on syndicate penalty bids, however. This proposal was supported by the IPO Advisory Committee.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which require, among other things, that NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the new, specifically targeted provisions in the proposed rule changes will aid member compliance efforts and help to maintain investor confidence in the capital markets.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

NASD requested written comments in NtM 02-55 and received four comment letters.⁵ All of the comment letters generally supported the proposal. The National

⁵ National Venture Capital Association letter to Barbara Z. Sweeney (Sept. 9, 2002); the Association for Investment Management and Research letter to Barbara Z. Sweeney (Sept. 23, 2002); North American Securities

Venture Capital Association, the Association for Investment Management and Research (“AIMR”) and the North American Securities Administrators Association, Inc. (“NASAA”) supported the amendments. NASAA noted that many of the prohibitions go to conduct that already is unlawful.

The Securities Industry Association (“SIA”) stated that “the new and specifically targeted provisions in Rule 2712 would aid member compliance efforts and help to maintain investor confidence in the capital markets.” The SIA supports proposed Rule 2712(a) but has concerns about how “excessive” compensation might be interpreted and suggests that the term be changed to “clearly excessive.” NASAA also noted that “excessive” compensation is not defined in the Rule and believes the term creates an exception that undermines the clarity of the provision. NASD believes that use of an “excessive” compensation standard takes into account all of the facts and circumstances surrounding the services provided. This flexibility would allow members and NASD to take into account the risk and effort involved in the transaction, usual and customary rates charged for similar services at broker/dealers in the same kind of business, and regional norms in setting prices for financial services.

As published in NtM 02-55, proposed Rule 2712 would have prohibited certain forms of aftermarket tie-in agreements. The SIA recommended that the language in the discussion section on aftermarket tie-ins “clarify that inquiries and discussions regarding a potential customer’s interest in purchasing and holding a security not be deemed solicitations for purposes of [the aftermarket tie-in provision].” AIMR believes the provision may be difficult to supervise or monitor and suggests that NASD “simply

require heightened supervisory scrutiny of all IPO allocations and distributions.” NASD has determined not to pursue a proposed rule change addressing aftermarket tie-in arrangements at the present time.

The SIA supported the proposal to prohibit allocations to an executive officer or director as a condition or as consideration for investment banking business, but noted that it may be difficult to determine whether an allocation has been done as a condition or as consideration for investment banking business. The proposal as amended would bar IPO allocations to all executive officers and directors of a company with whom a member has an investment banking relationship.

As proposed in the NtM 02-55, the amendments to Rule 2710 would have required that a member file a statement with NASD regarding whether an executive officer or director participated in the selection of the book-running managing underwriter. The SIA noted that underwriters cannot know with certainty who participated in their selection or the significance of their roles. In addition, the SIA believes that the proposed requirement to file information under Rule 2710(b)(6)(A)(viii) with respect to the 180-day calendar period immediately following the effective date of an offering would be burdensome. As discussed above, NASD has modified the proposal to eliminate the proposed amendment to Rule 2710.

The SIA recommends that the time period specified in proposed Rule 2712(c)(2)(A) commence on the offering date instead of the effective date of an offering. The SIA notes that the offering date tracks the language used in the standard agreement among underwriters, which is used by member firms to track the period in which a penalty bid may be used. NASD has amended the proposal to make the change suggested

by the SIA. Accordingly, the “offering date” for purposes of the rule is the date after pricing on which members first sell shares to the public.

As proposed in NtM 02-55, proposed Rule 2712 would have included a requirement that each member subject to the rule must adopt and implement written procedures reasonably designed to ensure that the member and its employees comply with the provisions of the rule. NASAA notes that members already are required to implement procedures to ensure compliance with NASD rules and the provision is unnecessary. NASD agrees that such procedures already are required by members and the provision has been deleted.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the

Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Margaret H. McFarland
Deputy Secretary