

Notice to Members

NOVEMBER 2003

SUGGESTED ROUTING

Corporate Financing
Legal & Compliance
Senior Management
Trading & Market Making

KEY TOPICS

IPO Allocations
IPO Pricing
Rule 2710
Rule 2712
Underwriting Compensation

REQUEST FOR COMMENT ACTION REQUESTED BY JANUARY 9, 2004

Proposed Rule Governing Allocations and Distributions of Shares in Initial Public Offerings (IPOs)

Request for Comment on Regulatory Approaches to Enhance IPO Pricing Transparency; **Comment Period Expires January 9, 2004**

Executive Summary

NASD is proposing additional amendments to proposed Rule 2712—IPO Allocations and Distributions. On September 15, 2003, NASD filed with the Securities and Exchange Commission (SEC) proposed Rule 2712 to prohibit certain abuses in the allocation and distribution of shares in IPOs.¹ The additional amendments would implement several recommendations of the NYSE/NASD IPO Advisory Committee (IPO Advisory Committee or Committee), which was established at the request of the SEC. On May 29, 2003, the IPO Advisory Committee issued a report with 20 recommendations for the self-regulatory organizations (SROs) and the SEC to enhance public confidence in the integrity of the IPO process.

The proposed amendments to proposed Rule 2712 would address the following recommendations of the NYSE/NASD IPO Advisory Committee for SRO rulemaking:

- ▶ Require the lead managing underwriter to disclose indications of interest and final allocations to the issuer's pricing committee;
- ▶ Prohibit acceptance of market orders to purchase IPO shares in the aftermarket for one trading day following an IPO;
- ▶ Impose procedures designed to ensure that reneged IPO allocations are not used to benefit favored clients of the underwriter;

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- ▶ Require that any lock-up that applies to shares owned by the issuer's officers and directors also applies to shares they purchase in "friends and family" programs; and
 - ▶ Impose new notification requirements when underwriters waive lock-ups.

The *Notice* also requests comment on various additional regulatory steps that might be adopted to promote transparency in IPO pricing. These possible approaches, which could be adopted as alternatives, include requiring underwriters to:

- ▶ Retain an independent broker/dealer to opine that the initial IPO price range at which the offering is marketed and the final offering price are reasonable and to require that the independent broker/dealer's opinion is disclosed in the prospectus; or
- ▶ Use an auction or other system to collect indications of interest to help establish the final IPO price; or
- ▶ Include a "valuation disclosure" section in the prospectus with information about how the managing underwriter and issuer arrived at the initial price range and final IPO price, such as the issuer's one-year projected earnings or P/E ratios and share price information of comparable companies.

Action Requested

NASD requests comment on the proposed amendments. Members wishing to comment must make a submission that is received by January 9, 2004. Members and interested persons can submit their comments using the following methods:

- ▶ Mailing in written comments
- ▶ E-mailing written comments to pubcom@nasd.com
- ▶ Submitting comments online at the NASD Web Site (www.nasd.com)

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Important Notes: The only comments that will be considered are those submitted by e-mail or in writing.

Before becoming effective, any rule change developed as a result of comments received must be adopted by NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

Questions/Further Information

As noted, written comment should be submitted to Barbara Z. Sweeney. Questions concerning this *Notice* should be directed to Thomas M. Selman, Senior Vice President, Corporate Financing/Investment Companies, NASD, at (240) 386-4623; Joseph E. Price, Vice President, Corporate Financing Department, NASD, at (240) 386-4623; or Gary L. Goldsholle, Associate General Counsel, Office of General Counsel, NASD, at (202) 728-8104.

Discussion

On August 22, 2002, the SEC requested that NASD and the New York Stock Exchange (NYSE) convene a high-level group of business and academic leaders to review the IPO process, to recommend ways to address the problems evidenced during the hot market of the late-1990s and 2000, and to improve the underwriting process. The NYSE/NASD IPO Advisory Committee met frequently in 2002 and early 2003 and issued its final report, containing 20 recommendations, in May 2003.

1. Rulemaking to Implement IPO Committee Proposals

NASD published *Notice to Members 02-55* in August 2002, requesting comment on proposed Rule 2712, which addressed allocation abuses. In September 2003, NASD filed with the Commission proposed Rule 2712 with modifications to the original proposal to reflect IPO Advisory Committee comments.² The amendments proposed today would supplement proposed Rule 2712 by addressing the IPO Advisory Committee recommendations described below:

a. Disclosure of Indications of Interest and Final Allocations

The IPO Advisory Committee recommended that issuers establish a pricing committee to evaluate the proposed offering price, and that underwriters be required to disclose to the issuer's pricing committee all indications of interest received before the issuer finalizes the IPO price. The Committee also recommended that underwriters be required to disclose to the issuer the final allocations after the offering is priced.

The Committee concluded that greater participation by issuers in pricing and allocation decisions would better ensure that those decisions are consistent with the fiduciary duty of directors and management, and would provide management with more information to evaluate the underwriter's performance. A requirement that issuers establish a pricing committee would necessitate a listing standard by The Nasdaq Stock Market and the NYSE.

NASD's proposed rule would require that the book-running manager(s) disclose indications of interest to a pricing committee, or to the issuer's board of directors if the issuer has no pricing committee, and that the book-running manager(s) disclose to the issuer final allocations made by the manager(s).

NASD requests comment on whether disclosure of other information to issuers also would be useful. For example, should issuers receive other specified information about the managing underwriters' pricing analysis or allocation decisions?

b. Trading Restrictions

The IPO Advisory Committee recommended a prohibition on market orders for one trading day following an IPO. The Committee concluded that, in light of the volatility of IPO issues, investors who place market orders immediately following an IPO may inadvertently purchase at prices that neither reflect their true investment decisions nor their reasonable expectations. By disallowing market orders for the first trading day following an IPO, the Committee reasoned that the market will have time to develop trading information, thereby making subsequent uncapped orders less likely to cause harm to retail investors. The proposed rule would prohibit any member from accepting a market order to purchase IPO shares during the first trading day that the IPO shares commence trading in the secondary market. Investors would remain free to place limit orders during this time period.

The IPO Advisory Committee also offered a recommendation concerning IPO shares that are returned to the underwriter after completion of distribution. The Committee noted that currently, if an IPO's shares trade at an immediate aftermarket premium, underwriters can allocate returned shares to favored customers at the IPO price, providing what may be a risk-free investment to those customers. In order to eliminate the possibility that this practice will occur, the proposed rule would require underwriters to allot returned shares to the existing syndicate short position, then sell the remaining returned shares on the open market and return net profits to the issuer. When the market price does not rise above the offering price, the underwriter should be permitted to sell the shares for its account or retain the shares by placing them in its investment account.

c. Limitations on “Friends and Family” Programs

The IPO Advisory Committee offered several recommendations concerning issuer-directed allocations of IPO shares. Among those recommendations, the Committee recommended requiring that any lock-up that applies to shares owned by officers and directors include the shares purchased by those individuals in the “friends and family” program. The proposed rule would require that any lock-up or restriction on the transfer of the issuer’s shares apply to issuer-directed shares held by officers and directors of the issuer.

d. Requirements Concerning Lock-up Exemptions

The IPO Advisory Committee concluded that investors reasonably expect that the issuer’s directors, officers, and large pre-IPO shareholders who agree to “lock up” their shares will be bound by those agreements for the stated period. The Committee therefore recommended that:

- ▶ Prior to granting any exemption to a lock-up, underwriters be required to notify the issuer and the issuer should be required to file a Form 8-K with the SEC concerning the exemption; and
- ▶ Prior to the transaction, the lead underwriter announce the exemption through a major news service.

The proposed rule would require an underwriter to notify the issuer prior to granting a lock-up exemption and to announce the exemption through a national news service. The requirement that issuers file a Form 8-K would require SEC rulemaking.

e. Other IPO Committee Recommendations

The IPO Advisory Committee offered other recommendations that will not necessitate rulemaking. In particular, the Committee recommended additional requirements for enhanced periodic internal review by underwriters of their IPO supervisory procedures and a heightened focus on the IPO process by the SROs. The Committee also recommended an educational program for new issuers and IPO investors. NASD intends to take action on these recommendations through our examinations and educational programs.

2. Rulemaking Concerning the Pricing of Unseasoned Issuers

Most of the IPO Advisory Committee's recommendations addressed the manner in which IPO shares are allocated, rather than the method by which they are priced. However, the IPO Advisory Committee did examine the pricing issue in two key respects:

- ▶ First, the IPO Advisory Committee recommended that regulators review existing rules and practices in order to promote the development of alternatives to the bookbuilding process. In particular, the Committee was interested in whether regulators could take any steps to foster development of the "Dutch Auction" system of price discovery.
- ▶ Second, the IPO Advisory Committee considered, but did not propose, a requirement that a prospectus provide an estimate of projected earnings in certain cases. Investment banks often provide projected earnings information to institutional investors, and this information is viewed as critical to the determination by institutional investors of whether IPO shares are fairly priced.

NASD requests comment on potential regulatory initiatives that would address the issue of fair and reasonable pricing of IPOs. After analyzing the comments received, we will determine whether to propose any new rules in this area.

Many IPO issuers in the late 1990s and 2000 had little or no revenues and subsequently experienced a dramatic run-up and decline in their stock price. Some critics have taken the position that the run-up demonstrates that these IPOs were underpriced; others have countered that the subsequent significant drop in the price of these securities, at times well below the IPO price, demonstrates that the offerings were actually overpriced. This debate suggests that some action may be appropriate to shed further light on IPO pricing.

Three possible approaches might be to require the managing underwriter to:

- ▶ Retain an independent broker/dealer to opine that the initial IPO price range at which the offering is marketed and the final offering price are reasonable and to require that the independent broker/dealer's opinion is disclosed in the prospectus; or
- ▶ Use an auction or other system to collect indications of interest to help establish the final IPO price; or
- ▶ Include a "valuation disclosure" section in the prospectus with information about how the managing underwriter and issuer arrived at the initial price range and final IPO price, such as the issuer's one-year projected earnings or P/E ratios and share price information of comparable companies.

NASD requests comment on these potential approaches, including the relative merits of each. Commenters should be aware that these three approaches are listed as alternatives. NASD is requesting comment on these concepts both as stand-alone proposals and as alternatives. Which alternative or set of alternatives is most likely to benefit issuers and investors? What other alternatives, if any, might address the pricing issue?

Should the reforms be adopted for the IPOs of all issuers or only for IPOs of “unseasoned” issuers? If the latter, how should seasoning be measured—for example, by three years of revenues, operating revenues, or net income? Would the reforms provide greater assurance that either unseasoned issuers are properly priced or that the methods by which their shares are valued are adequately disclosed?

Finally, NASD asks commenters to address the additional risk placed on the issuer and underwriters by the independent pricing opinion and valuation disclosure proposals. Before requiring issuers and underwriters to assume additional liability risk by including this information in IPO prospectuses, would it be appropriate or necessary for the SEC to consider rulemaking to provide issuers and underwriters with a safe harbor from liability? Today, Rule 175 under the Securities Act of 1933 provides a safe harbor, but only for projections that have a “reasonable basis” and are “made in good faith.” We have been informed that most issuers do not provide earnings projections under Rule 175 because of the litigation risk that is associated with these limitations. Section 27A of the Securities Act authorizes the SEC to provide a safe harbor that requires actual knowledge that a forward-looking statement is false before it becomes actionable. Currently, however, Section 27A does not apply to IPOs. Should the Section 27A safe harbor be expanded to IPOs if the independent pricing opinion or valuation disclosure reforms were required under NASD rules?

Endnotes

- 1 File No. SR-NASD-2003-140 (Sept. 15, 2003).
- 2 As proposed in *Notice to Members 02-55*, Rule 2712 addressed “quid pro quo” allocations, “spinning,” “laddering,” and inequitable penalty bids. The amended proposal filed in September 2003 did not include the laddering provision, and the prohibition on spinning was modified to reflect the IPO Advisory Committee’s recommendation that NASD bar IPO allocations to all executive officers and directors of a company with which a member has an investment banking relationship—not just allocations that constitute a quid pro quo for investment banking business.

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Rule 2712. Allocation and Pricing of Initial Public Offerings.

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(a) – (d) No changes from File No. SR-NASD-2003-140 (Sept. 15, 2003)

(e) IPO Pricing

No member may serve as the book-running lead manager of an initial public offering of equity securities (“IPO”) unless the IPO meets all of the following conditions:

(1) *Underwriting Agreement.* The agreement between the book-running lead manager and the issuer provides that:

(A) the book-running lead manager will provide the issuer’s pricing committee (or, if the issuer has no pricing committee, its board of directors):

(i) a regular report of indications of interest, including the names of interested investors and the number of shares indicated by each;

(ii) after the closing date of the IPO, a report of the final allocation of shares available to the manager, including the names of purchasers and the number of shares purchased by each;

(B) any lock-up or other restriction on the transfer of the issuer’s shares by officers and directors of the issuer will apply to their issuer-directed shares;

(C) at least two business days before the release or waiver of any lock-up or other restriction on the transfer of the issuer’s shares, the book- running lead manager will notify the issuer of the impending release or waiver and announce the impending release or waiver through a national news service;

(2) *Agreement Among Underwriters.* The agreement between the book-running lead manager and other syndicate members provides that with respect to any shares returned by a purchaser to a syndicate member after secondary market trading commences:

(A) the returned shares will be allotted to the existing short position of the syndicate;

(B) if no short position exists, or if all existing syndicate short positions have been covered, the returned shares will be sold on a national securities exchange or Nasdaq;

(C) in the event of any sales under paragraph (B), if the sales price exceeded the IPO price, the difference will be paid to the issuer;

(D) if the market price is less than the IPO price, then the syndicate member may either sell the shares under paragraph (B) or retain them in its own investment account.

(3) No member may accept a market order for the purchase of IPO shares during the first day that IPO shares commence trading on the secondary market.