

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Corporate Financing
Legal & Compliance
Registered Representatives
Senior Management
Trading & Market Making

KEY TOPICS

Flipping
IPO Allocations
NASD Rule 2710
NASD Rule 2712
Penalty Bids
Spinning
Underwriting Compensation

REQUEST FOR COMMENT

ACTION REQUESTED BY SEPTEMBER 9, 2002

Regulation of IPO Allocations and Distributions

NASD Requests Comment on Proposed New Rule 2712 (IPO Allocations and Distributions) and on an Amendment to Rule 2710 (Corporate Financing Rule); Comment Period Expires September 9, 2002.

Executive Summary

NASD is proposing to create new Rule 2712 and amend existing Rule 2710 to prohibit certain IPO allocation abuses. The federal securities laws¹ and existing NASD rules² already prohibit certain IPO allocation abuses. These laws and rules would continue to apply if NASD adopts proposed new Rule 2712. Nevertheless, new, specifically targeted provisions in Rule 2712 would aid member compliance efforts and help to maintain investor confidence in the capital markets. In particular, the proposal would expressly prohibit the following types of conduct:

- ♦ the allocation of IPO shares as consideration or inducement for the payment of excessive compensation for other services provided by the member;
- ♦ the solicitation of aftermarket orders for the allocation of IPO shares;
- ♦ the allocation of IPO shares to an executive officer or director of a company on the condition that the officer or director send the company's investment banking business to the member, or as consideration for investment banking services previously rendered; and
- ♦ the imposition of a penalty on registered representatives whose retail customers have "flipped" IPO shares when similar penalties have not been imposed with respect to syndicate members.

The proposal would require members to adopt procedures reasonably designed to ensure that the requirements and prohibitions in Rule 2712 are followed. The proposal also would amend Rule 2710 to allow NASD to collect certain data on potential “spinning” abuses from members. See Exhibits A and B for rule language.

Action Requested

NASD encourages all interested parties to comment on the proposal. Comments must be received by September 9, 2002. Comments should be mailed to:

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

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

Before becoming effective, any rule change developed as a result of comments received must be adopted by the 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 to Members — Request for Comment* may be directed to Joseph E. Price, Director, Corporate Financing Department, NASD Regulatory Policy and Oversight, at (240) 386-4623, or Gary Goldsholle, Associate

General Counsel, NASD, Regulatory Policy and Oversight, at (202) 728-8104.

Background

NASD is proposing new Rule 2712 and an amendment to Rule 2710. These rule changes will better ensure that members avoid unacceptable conduct when they engage in the allocation and distribution of IPOs. In addition, these rule changes are intended to sustain public confidence in the IPO process, which is critical to the continued success of the capital markets.

Members are reminded that 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. Moreover, members would have to ensure that their participation in the allocation and distribution of IPOs complies not only with Rule 2712, but with applicable federal securities laws and other NASD rules, including those referred to above.

1. 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 services, but any service offered by the member.

NASD does not intend that this prohibition interfere with legitimate customer relationships. For example, the prohibition 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. NASD requests comment on whether this provision appropriately balances the need to protect the integrity of the IPO allocation process with the desire to avoid undue interference with legitimate customer relationships.

2. Prohibition of Aftermarket Tie-in Agreements

Rule 2712(b) would expressly prohibit a member or an associated person that is participating in an IPO from requesting that a customer purchase shares in the aftermarket as a condition to being allocated shares in the IPO. In August 2000, the SEC's Division of Market Regulation issued *Staff Legal Bulletin No. 10*, in which it stated that requiring a customer to agree to buy additional shares in the aftermarket as a condition to being allocated shares in the distribution violates Rules 101 and 102 of Regulation M and may violate other anti-fraud and anti-manipulation provisions of the federal securities laws. The *Staff Legal Bulletin* explained that aftermarket tie-in agreements are a particularly egregious form of solicited transaction prohibited by Regulation M. The SEC staff wrote that "solicitations and tie-in agreements for aftermarket purchases are manipulative because they undermine the integrity of the market as an independent pricing mechanism." Rule 2712(b) would expressly prohibit these types of aftermarket tie-in agreements, thereby supplementing existing prohibitions in Regulation M and Rule 2110.

The proposed rule would prohibit discussions in which after-market

purchases are requested as a condition for the receipt of an IPO allocation. We request comment on this provision.

3. Prohibition of Spinning

Rule 2712(c) would expressly prohibit 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 prohibit IPO allocations to an executive officer or director as consideration for directing investment banking services previously rendered by the member to the company.

"Spinning" or awarding IPO shares to the executive officers and directors of the company 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.

Rule 2712(c) would prohibit the allocation of IPO shares on the condition that the executive officer or director send investment banking business to the member, or as consideration for previously directed investment banking business. The provision is not intended to prohibit a member from allocating IPO shares to a customer merely because the customer is an executive officer or director of a company.

NASD also is proposing 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 information would assist the staff in monitoring the

possibility that improper allocations to executive officers or directors may have occurred. This information also may alert the staff to allocations that could violate Rule 2712(a).

4. Restrictions on Penalty Bids

Rule 2712(d) would prohibit members from penalizing registered representatives whose customers have “flipped” IPO shares that they have purchased through the member, unless a penalty bid, as defined in Regulation M Rule 101 has been imposed. Rule 101 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.”

Regulation M and Nasdaq Stock Market Rule 4624 provide notice and recordkeeping requirements for penalty bids. Penalty bids typically are used 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 imposed 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 their flipping activity. 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, and the need to encourage institutional customers to remain committed to the issuer may therefore be greater. The proposed rule would effectively prohibit this selective practice by permitting members to impose 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.

5. Requirement for Procedures

Rule 2712(d) would require members to adopt procedures reasonably designed to ensure that the requirements and prohibitions in Rule 2712 are followed. The proposal would not mandate specific procedures that would apply to all members. Instead, it would permit members to tailor the required procedures to their particular corporate structure and the nature of their underwriting and distribution activities. Accordingly, members that do not engage in the allocation or distribution of IPOs would not be required to adopt procedures under Rule 2712.

Endnote

- 1 *E.g.*, Rules 10b-5 (Employment of Manipulative and Deceptive Devices) and Rule 100 (Regulation M).
- 2 *E.g.*, Rules 2110 (Standards of Commercial Honor and Principles of Trade), 2710 (Corporate Financing Rule), 2330 (Customers' Securities or Funds), 3010 (Supervision), and 3060 (Influencing or Rewarding Employees of Others).

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EXHIBIT A

Rule 2712. IPO Allocations and Distribution

(a) **Abusive 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) **Aftermarket Tie-in Agreements.** No member or person associated with a member that is participating in an IPO may request that a customer purchase shares in the aftermarket as a condition to being allocated shares in the IPO distribution.

(c) **Spinning.** No member or person associated with a member may allocate IPO shares to an executive officer or director of a company:

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

(2) as consideration for directing investment banking services previously rendered by the member to the company.

(d) **Policies Concerning Flipping.** 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 as a penalty or disincentive for selling the shares to a customer that engaged in flipping, unless the managing underwriter has assessed a penalty bid on the member.

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

(2) Definitions

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

(A) "Flipping," means the initial sale of IPO shares purchased in an offering within 30 days following the effective date of such offering.

(B) "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.

(e) **Supervisory Procedures.** Each member subject to this rule must adopt and implement written procedures reasonably designed to ensure that the member and its employees comply with the provisions of this rule.

EXHIBIT B

New language is underlined.

Rule 2710. Corporate Financing Rule – Underwriting Terms and Arrangements

* * *

(b) Filing Requirements

(1) – (3) No change

(4) Requirement for Filing

(A) Unless filed by the issuer, the managing underwriter, or another member, a member that anticipates participating in a public offering of securities subject to this Rule shall file with the Association the documents and information with respect to the offering specified in subparagraphs (5) and (6) below no later than one business day after the filing of any such documents:

* * *

; provided, however, that the information required under Rule 2710(b)(6)(A)(viii) must be filed no later than 15 calendar days after the conclusion of the 180 calendar-day period immediately following the effective date of the offering.

(5) No change

(6) Information Required to be Filed

(A) Any person filing documents with the Association pursuant to subparagraph (4) above shall provide the following information with respect to the offering:

(i) - (vi) No change.

(vii) a statement regarding whether any executive officer or director of the issuer acquired from the book-running managing underwriter of the public offering any shares in an initial public offering of securities ("IPO") during the 180 calendar-day period immediately preceding the required filing date of the offering. For each executive officer or director of the issuer who acquired those IPO shares, the statement must disclose:

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- a. the name of the executive officer or director;
- b. the date of the IPO, the name of the issuer in the IPO, the number of securities purchased or received by the executive officer or director and the price paid for those securities;
and
- c. whether the executive officer or director participated in any capacity in the selection of the book-running managing underwriter for the issuer's public offering.
- (viii) a statement containing the information required in Rule 2710(b)(6)(vii)(a)-(c) if any executive officer or director of the issuer purchases or acquires from the book-running managing underwriter any shares in an IPO within 180 calendar days after the effective date of the offering.