

August 4, 2004

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. 2**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find Amendment No. 2 to the above-numbered rule filing. 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 Vice President and Associate General Counsel, 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,

Marc Menchel
Executive Vice President and
General Counsel

Enclosures

File No. SR-NASD-2003-140
Consists of 160 Pages
August 4, 2004
Amendment No. 2

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.

* * * * *

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 a person materially supported by such 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 investment banking business from the company in the next 6 months; or

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

For purposes of paragraph (b)(2), a member that allocates IPO shares to an executive officer or director of a company, or a person materially supported by such officer or director, from which it receives investment banking business in the next 6 months will be presumed to have made the allocation with the expectation or intent to receive such business. A member, however, may rebut this presumption by demonstrating that the allocation of IPO shares was not made with the expectation or intent to receive investment banking business.

(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 entire syndicate.

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

(e) IPO Pricing and Trading Practices

In an equity IPO:

(1) Reports of Indications of Interest and Final Allocations. The book-running lead manager must provide to the issuer’s pricing committee (or, if the issuer has no pricing committee, its board of directors):

(A) a regular report of indications of interest, including the names of interested institutional investors and the number of shares indicated by each, as reflected in the book-running lead manager’s book of potential institutional orders, and a report of aggregate demand from retail investors;

(B) after the settlement date of the IPO, a report of the final allocation of shares to institutional investors as reflected in the books and records of the book-running lead manager including the names of

purchasers and the number of shares purchased by each, and aggregate sales to retail investors;

(2) Lock-Up Agreements.

(A) Any lock-up agreement or other restriction on the transfer of the issuer's shares by officers and directors of the issuer shall provide that such restrictions will apply to their issuer-directed shares; and

(B) 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 major news service;

(3) Agreement Among Underwriters. The agreement between the book-running lead manager and other syndicate members must require that any shares returned by a purchaser to a syndicate member after secondary market trading commences be used to (a) offset the existing syndicate short position or (b) if no syndicate short position exists, the member must offer returned shares at the public offering price to unfilled customers' orders pursuant to a random allocation methodology.

(4) Market Orders. 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.

* * * * *

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.

At its meeting on November 12, 2003, the Board of Directors of NASD Regulation, Inc. approved publication of a subsequent Notice to Members requesting comment on amendments to new Rule 2712 and authorized the filing of the amendments to the proposed rule change with the SEC. In November 2003, NASD issued Notice to Members 03-72. 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 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 90 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 Vice President and 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

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.

In August 2002, the SEC requested that NASD and the 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. In May 2003, the NYSE and NASD IPO Advisory Committee ("Committee") issued its final report, which contains 20 recommendations. In November 2003, NASD published Notice to Members 03-72 requesting comment on the Committee's recommendations applicable to NASD. The proposals in Notice to Members 03-72 supplemented proposals initially presented for comment in Notice to Members 02-55, which were filed with the SEC on September 15, 2003 and amended on December 9, 2003. NASD received 39 comment letters¹ in response to Notice to Members 03-72, which are discussed below.

¹ Letter from Alan R. Gordon dated November 25, 2003; Letter from Alan Tobey dated November 28, 2003; Letter from Allen Skaggs dated November 30, 2003; Letter from Peter W. LaVigne, American Bar Association, dated February 4, 2004; Letter from Banner Capital Markets LLC dated January 9, 2004; Letter from Bruce E. Holmes, PE, dated November 29, 2003; Letter from Harold Jones, Coughlin & Company Inc., dated January 9, 2004; Letter from Daniel M. Chernoff dated November 28, 2003; Letter from Don Brewer dated November 28, 2003; Letter from Edward J. Fedeli dated November 28, 2003; Letter from Edward M. Alterman, Fried, Frank, Harris, Shriver & Jacobson LLP, dated January 23, 2004; Letter from HGM dated November 28, 2003; Letter from J D Harris dated November 28, 2003; Letter from

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. 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

Jandonbar@aol.com dated November 30, 2003; Letter from Jeffrey E. Teich, Ph.D, dated November 25, 2003; Letter from Lertel7635@aol.com dated November 29, 2003; Letter from Malcolm R. Powell, M.D, dated November 28, 2003; Letter from Mandar Mirashi dated November 29, 2003; Letter from Mark H. Rapier dated November 30, 2003; Letter from Lawrence M. Ausubel, Market Design Inc., dated January 23, 2004; Letter from Mohme@aol.com dated November 29, 2003; Letter from Lester Morse, Esq., Morse & Morse, PLLC dated January 15, 2004; Letter from Jed Bandes, Mutual Trust Co. of America Securities, dated November 28, 2003; Letter from Ralph A. Lambiase, NASAA, dated January 26, 2004; Letter from Mark G. Heesen, NVCA, dated January 16, 2004; Letter from Henry P. Williams, Oppenheimer & Co., Inc., dated January 9, 2004; Letter from Patricia Evans dated November 29, 2003; Letter from Paul N. Mullen dated November 28, 2003; Letter from Peggy Hutchinson dated November 29, 2003; Letter from Peter Locke dated November 28, 2003; Letter from RAMSkMgt@yahoo.com dated November 28, 2003; Letter from Richard O. Gregory dated November 29, 2003; Letter from Rick Street dated November 29, 2003; Letter from Scott Cook dated January 23, 2004; Letter from John Faulkner, Securities Industry Association, dated January 23, 2004; Letter from Steve Antenozzi dated November 27, 2003; Letter from Thomas Weitzner dated November 30, 2003; Letter from Dr. Ann E. Sherman, University of Notre Dame, January 23, 2004; and Letter from William R. Hambrecht, WR Hambrecht & Co., dated January 9, 2004.

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.

In Notice to Members 03-72, NASD solicited comment on a proposed rule change that would require that the underwriting agreement between the book-running lead manager and the issuer require that the book-running lead manager provide the issuer's pricing committee (or its board of directors if the issuer does not have a pricing committee) with: (1) a regular report of indications of interest, including the names of interested investors and the number of shares indicated by each, and (2) 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.

Commenters generally supported these requirements but suggested the following changes.

1. Institutional vs. Retail Disclosure

Some commenters suggested that the report of indications of interest and final allocations should relate only to the "institutional pot." Several commenters suggested that it is not practical for the book-running lead manager to provide the names of all individual investors who have expressed an indication of interest because the book-running lead manager does not collect the names of individual retail investors.

Commenters also stated that brokerage firms consider the names of their individual investor clients to be proprietary information and confidentiality concerns may limit the

ability of brokerage firms to disclose the names of individual investors to the book-running lead manager. Commenters also stated that retail indications of interest are usually submitted to a firm's syndicate desk as branch aggregates, not on an individual-by-individual basis. Finally, commenters suggested that information regarding the names of individual investors is likely to be of limited use to an issuer because, in an IPO, there could be thousands of individual investors.

NASD staff agrees that disclosure of each retail customer's indications of interest (and subsequent allocations) would be of limited benefit to issuers and their pricing committees. The underlying purpose of this proposal is to ensure that the issuer or its pricing committees has a clear picture of the demand for its securities. Thus, information about each individual retail investor would generally not be helpful. Accordingly, the staff has revised the proposed rule change to require that the book-running lead manager disclose its institutional book of interest and to reflect retail demand in aggregate terms only.

2. Timing of Disclosure

One commenter suggested that rather than a "regular report" of indications of interest, the rule should require that the book-running lead manager provide information in a timely manner prior to pricing, or as frequently as requested by the issuer's pricing committee. Another commenter suggested that the book-running lead manager should be required to provide a single report of the major institutional indications of interest shortly before or at the time of pricing the offering.

The proposed rule would require a regular report of indications of interest, which report should be made as often as appropriate, including such as when a material change

occurs, or in connection with certain meetings with the issuer or its pricing committee, and always as frequently as requested by an issuer or its pricing committee. Indeed, our understanding of the bookbuilding process is that most underwriters have frequent and even daily discussions with issuers about the level of indications of interest. The proposed rule change thus would codify this practice.

In response to one commenter, however, NASD staff has amended the proposed rule change to require the book-running lead manager to provide the report on final allocations within a reasonable time after “settlement date” rather than after “closing date.” The settlement date and closing date can be the same date, but the term “settlement date” may be more precisely understood as the date on which the issuer transfers its shares in return for offering proceeds from the syndicate.

3. Additional Disclosure

One commenter suggested that issuers would benefit from receiving information regarding relationships that underwriters have with purchasers. This commenter suggested that issuers would benefit from receiving additional information regarding the intended holding periods of purchasers, since issuers generally favor allocations to long-term holders over “flippers.”

This information generally may be useful or relevant to issuers. As the specificity of information about past account activity increases, however, financial privacy concerns also increase. Brokerage customers may reasonably expect that their broker will keep particular information about trades they have made in their accounts confidential. In addition, SEC Regulation M prohibits underwriters during the bookbuilding process from attempting to induce purchases in the aftermarket. This limits some of the information

the underwriters are permitted to obtain and provide to the issuer regarding whether any particular account will be buying or selling the securities in the aftermarket.

Accordingly, NASD staff has not included this requirement as part of the proposed rule change.

One commenter suggested that disclosure of different levels of interest at different prices should be required and that NASD should require a graphical display of this information. NASD staff believes that members should be able to design their forms of communication on indications of interest and final allocations as appropriate to particular offerings and issuers. Members, of course, may compete for investment banking business by offering certain disclosures and forms of disclosure, and likewise, issuers may condition an engagement with an investment bank on certain disclosures and forms of disclosure.

4. Underwriting Agreements

Several commenters stated that the obligation to provide indications of interest to the issuer should not be included in the underwriting agreement because the underwriting agreement is not signed until after pricing of the offering. These commenters suggested that NASD impose the obligation on the book-running lead manager directly. NASD staff agrees and has amended the proposed rule change accordingly.

b. Limitation on Market Orders for One Day Following an IPO

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. Commenters, such as the SIA, generally opposed this proposal. Some commenters suggested that educating retail investors about the appropriate use of limit orders was the appropriate remedy. Commenters also stated that restricting investors only to limit orders on the first day of trading will artificially constrain trading activity and could impair the process by which a market price is determined.

NASD staff is not persuaded by the commenters that banning market orders for IPOs on the first trading day will have significant effects on liquidity or price discovery. Institutional investors rely almost exclusively on limit orders in the IPO aftermarket. NASD staff requests further comment on why the use of limit orders by retail investors will not allow markets to develop sufficient liquidity or become an effective tool for price discovery.

c. Returned Shares

The IPO Advisory Committee 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 might be a guaranteed profit to those customers. To address this concern, NASD solicited comment on a proposed rule change that would require underwriters first to allot returned shares to the existing syndicate short position. If there is no short position, or if the short position already has been covered by the time the shares are returned, the proposal would have permitted members to sell the remaining returned shares on the open market and return net profits to the issuer. The proposed rule change provided that

if the market price does not rise above the offering price, then the underwriter would be permitted to sell the shares at a loss for its account or retain the shares by placing them in its investment account.

Commenters and SEC staff raised concerns that the proposal's disposition of returned shares in the event that there is no existing short position may conflict with Regulation M. In response to these concerns, NASD staff has amended the proposed rule change to require that if no existing short position exists at the time that returned shares are received by a member firm, then the members must offer those shares to unfilled customers' orders at the public offering price pursuant to a random allocation methodology. While the proposed rule change does not specify a particular methodology, NASD staff expects that members will develop systems similar to those used to allocate options exercise notices.² In general, these systems will require sequencing of all relevant accounts, assigning a sequence number to each account, and then generating a random number to identify where in the sequence to begin offering returned shares. In requiring the use of a random allocation methodology, NASD prevents members from being in a position to benefit by selecting a particular customer or group of customers to receive a guaranteed profit.

d. Limitations on "Friends and Family" Programs

The IPO Advisory 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. In Notice to Members 03-72, NASD solicited comment on a proposed rule change to require that any lock-up or restriction on the transfer of the issuer's shares also apply to issuer-directed shares held by officers and

² See Rule 2860(b)(23)(C).

directors of the issuer. Commenters generally supported this proposal. One commenter believed that this proposal should be effected by a listing requirement rather than an NASD rule. NASD staff disagrees. Insofar as the lock-up agreement is a contractual arrangement between the underwriter and the issuer, we believe that imposing the requirement on the underwriter is appropriate.

e. 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 recommended that the lead underwriter announce any lock-up exemption through a major news service. NASD's proposed rule change would require that the underwriting agreement provide that 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.

Several commenters expressed concern that requiring the book-running lead manager to announce an impending release or waiver of a lock-up restriction on officers and directors would result in a large amount of meaningless information regarding sales of immaterial amounts of securities. NASD staff disagrees. Lock-up restrictions generally align the investment interest of the insiders subject to the lock-up with investors in the offering during the period of the lock-up. Investors should find notifications of a lock-up release or waiver to be important and relevant information.

Another commenter questioned whether this notification requirement was intended to apply to the release of the issuer, selling shareholder, or both. NASD's proposed rule change will apply to a release or waiver of lock-ups by the issuer and any selling shareholder. While in many cases the release of an issuer will be followed by the filing of a registration statement before securities may be sold, that is not always the case (e.g., Rule 144A offerings). Accordingly, NASD staff has not proposed to exempt waiver of issuer lock-ups from the proposed rule change.

One commenter also suggested that the notice requirement should be subject to some materiality or de minimis exception and should apply only if the release relates to a sale into the market. This commenter suggested that the notification requirement should not apply to a release that allows only for minor sales or transfers of stock in which the transferee agrees to lock-up restrictions identical to those applicable to the transferor, such as transfers by a shareholder to a family trust or to a charity. NASD staff does not support this modification. NASD staff believes that investors expect that lock-ups will be applied for their stated term, and that even small sales may be material information. NASD staff also does not believe that there should be an exemption where the transferee agrees to identical lock-up restrictions. The fact that the shareholder or issuer no longer has accepted investment risk with regard to those securities is information that should be available to the market. In addition, if a transferee agrees to identical lock-up restrictions, any waiver or release of such restrictions as applied to such persons also must be preceded by a public announcement through a major news service.

A commenter suggested that the timing of the announcement should be based upon when a sale into the market may first take place, not when the release is to take

place. Another commenter stated that two days' prior notice might not be sufficient. NASD staff believes that the timing of the announcement should be triggered by the release date, not the eventual sale date, and that two days seems to be an acceptable period.³ In addition, if the waiver does not permit the immediate sale of securities into the market, then additional disclosure should be provided indicating when such sales may be permitted.

Finally, one commenter believed that disclosure by the issuer in Form 8-K would be sufficient. NASD disagrees. Form 8-K notification occurs after a sale has been made. NASD agrees with the IPO Advisory Committee that investors expect that lock-ups will be adhered to, and that they should be provided advance notice of any release or waiver.

f. Rulemaking Concerning the Pricing of Unseasoned Issuers

As discussed in Notice to Members 03-72, 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. NASD solicited comment on three possible approaches to the regulation of IPO pricing of unseasoned issuers. Unlike the other items in Notice to Members 03-72, these were presented as concepts only and NASD did not propose specific rule text.

The first proposal was a requirement for an underwriter to retain an independent broker-dealer to opine that the initial IPO range at which the offering is marketed and the

³ Tying the period of prior notice to a particular market or the average trading volume, as suggested by one commenter, would, in NASD staff's view, be unnecessarily complex.

final offering price are reasonable and require that the independent broker-dealer's opinion is disclosed in the prospectus. Commenters generally did not support this proposal. The most common criticism was that the proposal would impose considerable cost on issuers. Commenters added that the cost of the independent opinion would be especially burdensome on smaller issuers. One commenter believed that the cost for the opinion would be affected by the assumption of liability that would result from the requirement to disclose the independent opinion in the prospectus. Another commenter argued that the responsibility for recommending a public offering price should not be forced on another broker-dealer that is less involved in the offering process and likely to be less informed about the issuer and its securities. Several commenters noted that the independent broker-dealer rendering a pricing opinion would need to rely on information from the lead underwriter, or due diligence costs would be prohibitive. Finally, one commenter noted that issuers already have the ability to obtain independent pricing opinions from a second broker-dealer when they perceive a need for one.

In light of these concerns, NASD staff does not intend to propose a rule requiring an independent pricing opinion at this time.

The second proposal was to require the managing underwriter to use an auction or other system to collect indications of interest to help establish the final IPO price. Commenters expressed varying degrees of support for this proposal. Many commenters that appear to be individual investors supported implementation of the "Dutch Auction" though they offered little explanation. Other commenters opposed the adoption of any regulation that would require underwriters to use an auction approach to price setting. Several commenters stated that the market, and not regulators, should decide what pricing

and allocation models are appropriate for particular IPOs. One commenter supported the development of alternatives to the bookbuilding process, but would not support the use of an auction as the only alternative. Finally, one commenter stated that the auction method is impractical for small broker-dealers because they are not familiar with this pricing mechanism.

Recent developments have focused increased attention on the use of auctions, and it appears that more issuers and investment banks are using or considering the use of auctions to assist in pricing IPOs. Given these developments, NASD staff finds it premature to mandate use of auction systems.

The third proposal was to require the managing underwriter to 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 reviewing the issuer's one-year projected earnings or P/E ratios and share price information of comparable companies. Commenters expressed varied levels of support for this proposal. Some commenters strongly supported the proposed valuation disclosure requirement. One such commenter suggested that the valuation disclosure should be accompanied by an explicit fiduciary duty making underwriters accountable for their IPO pricing decisions. This commenter expressed concern that valuation rationales and earnings estimates generally are made available only to the institutional market through the book-running underwriter's research analyst, creating an "information monopoly" that is inaccessible to smaller institutions and retail investors. This commenter stated that the inclusion of earnings estimates in the prospectus is a very

important step in allowing all investors to receive equal access to IPO pricing information in order for the lead underwriter to develop a complete and accurate demand curve.

Several commenters noted that the initial price range and final price reflect a large number of factors, including current market conditions. One commenter noted that pricing determinations are based not only on information about the issuer, its past results, current financials, and projected earnings, but also on information about market interest, performance of the stock market in the days preceding pricing, and the willingness of the issuer to accept a lower share price to sell into a down market. Some commenters noted that much pricing information, such as the selection of comparable companies is subjective. One commenter noted that projections of future earnings are one of many data points used by investors to determine the price and quantity of shares they are interested in purchasing. This commenter noted that the market ultimately determines price, and price may be driven by “market psychology” and other factors that are difficult to quantify.

Several commenters also expressed reservations about the valuation disclosure proposal because it would open the issuer and underwriter to future litigation if the projections were not met. Some commenters suggested that any proposal related to disclosure of issuer projections would need to be accompanied by a safe harbor to protect issuers and underwriters from liability in future litigation. These commenters generally favored expansion of the safe harbor under Section 27A of the Securities Act of 1933 to IPOs.

Some commenters suggested that the SEC, rather than NASD, should address the matter of valuation disclosure since it involves a disclosure requirement for issuers. One

commenter added that the SEC also would be able to address the attendant liability concerns affecting issuers and underwriters.

Based on the comments received, NASD believes that the SEC is the more appropriate regulator to address the inclusion of projections. The SEC regulates the contents of a prospectus and also is in a position to address issues of liability.

g. Spinning

NASD staff also has made certain amendments to paragraph (b)(2) of the proposed rule change addressing spinning. In particular, NASD staff has expanded the prohibition to preclude allocations to executive officers or directors of a company if the member expects to receive or intends to seek investment banking business from the company in the next 6 months. Previously, the proposed rule change only looked forward 3 months.

In addition, the proposed rule change adds a presumption in paragraph (b)(2), stating that if a firm allocates IPO shares to an executive officer or director of a company and it subsequently receives investment banking business from that company, that the IPO allocations were made with the expectation or intent to receive such business. A member may rebut this presumption. Evidence to rebut this presumption could include procedures and information barriers that ensure that investment banking personnel involved in allocations do not have any information about the beneficial owners of retail accounts that received allocations.

The proposed rule change also eliminates the definition of immediate family and instead applies the prohibition on spinning just to persons “materially supported” by an executive officer or director of a company. This change narrows the scope of the

spinning prohibition to include only those members of the immediate family that live in the same household as the executive officer or director and is similar in scope to the provisions in Rule 2711 (Research Analysts and Research Reports). The definition, however, captures persons outside of an executive officer's or director's immediate family if such executive officer or director, directly or indirectly, provides more than 25% of the person's income in prior calendar year. This concept of material support is the same as used in Rule 2790 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings).

(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 Notice to Members 03-72 as discussed in Section 3(a) above.

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.
2. NASD Notice to Members 03-72 (November 2003).
3. Comments received in response to NASD Notice to Members 03-72 (November 2003).
4. Changes in the text of the proposed rule change in Amendment No. 2 from Amendment No. 1.

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: _____
Marc Menchel, Executive Vice President and
General Counsel

Date: August 4, 2004

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-

; File No. SR-NASD-2003-140)

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 _____, 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 amendments to the rule change as proposed to the SEC on December 9, 2003 and as proposed in NASD Notice to Members 03-72. Proposed new language is underlined; proposed deletions are bracketed.

* * * * *

2712. IPO Allocations and Distributions

(a) Quid Pro Quo Allocations

1 15 U.S.C. § 78s(b)(1).

2 17 CFR § 240.19b-4.

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 a person materially supported by such 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 investment banking business from the company in the next 6 months; or

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

For purposes of paragraph (b)(2), a member that allocates IPO shares to an executive officer or director of a company, or a person materially supported by such officer or director, from which it receives investment banking business in the next 6 months will be presumed to have made the allocation with the expectation or intent to receive such business. A member, however, may rebut this presumption by demonstrating that the allocation of IPO shares was not made with the expectation or intent to receive investment banking business.

(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 entire syndicate.

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

(e) IPO Pricing and Trading Practices

In an equity IPO:

(1) Reports of Indications of Interest and Final Allocations. The book-running lead manager must provide to the issuer's pricing committee (or, if the issuer has no pricing committee, its board of directors):

(A) a regular report of indications of interest, including the names of interested institutional investors and the number of shares indicated by each, as reflected in the book-running lead manager's book of potential institutional orders, and a report of aggregate demand from retail investors;

(B) after the settlement date of the IPO, a report of the final allocation of shares to institutional investors as reflected in the books and records of the book-running lead manager including the names of purchasers and the number of shares purchased by each, and aggregate sales to retail investors;

(2) Lock-Up Agreements. Any lock-up agreement or other restriction on the transfer of the issuer's shares by officers and directors of the issuer shall provide that:

(A) Any lock-up agreement or other restriction on the transfer of the issuer's shares by officers and directors of the issuer shall provide that such restrictions will apply to their issuer-directed shares; and

(B) 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 major news service;

(3) Agreement Among Underwriters. The agreement between the book-running lead manager and other syndicate members must require that any shares returned by a purchaser to a syndicate member after secondary market trading commences be used to (a) offset the existing syndicate short position or (b) if no syndicate short position exists, the member must offer returned shares at the public offering price to unfilled customers' orders pursuant to a random allocation methodology.

(4) Market Orders. 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.

* * * * *

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

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.

In August 2002, the SEC requested that NASD and the 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. In May 2003, the NYSE and NASD IPO Advisory Committee ("Committee") issued its final report, which contains 20 recommendations. In November 2003, NASD published Notice to Members 03-72 requesting comment on the Committee's recommendations applicable to NASD. The proposals in Notice to Members 03-72 supplemented proposals initially presented for comment in Notice to Members 02-55, which were filed with the SEC on September 15, 2003 and amended on December 9, 2003. NASD received 39 comment letters² in response to Notice to Members 03-72, which are discussed below.

² Letter from Alan R. Gordon dated November 25, 2003; Letter from Alan Tobey dated November 28, 2003; Letter from Allen Skaggs dated November 30, 2003; Letter from Peter W. LaVigne, American Bar Association, dated February 4, 2004; Letter from Banner Capital Markets LLC dated January 9, 2004; Letter from Bruce E. Holmes, PE, dated November 29, 2003; Letter from Harold Jones, Coughlin & Company Inc., dated January 9, 2004; Letter from Daniel M. Chernoff dated November 28, 2003; Letter from Don Brewer dated November 28, 2003; Letter from Edward J. Fedeli dated November 28, 2003; Letter from Edward M. Alterman, Fried, Frank, Harris, Shriver & Jacobson LLP, dated January 23, 2004; Letter from HGM dated November 28, 2003; Letter from J D Harris dated November 28, 2003; Letter from Jandonbar@aol.com dated November 30, 2003; Letter from Jeffrey E. Teich, Ph.D, dated November 25, 2003; Letter from Lertel7635@aol.com dated November 29, 2003; Letter from Malcolm R. Powell, M.D, dated November 28, 2003; Letter from Mandar Mirashi dated November 29, 2003; Letter from Mark H. Rapier dated November 30, 2003; Letter from Lawrence M. Ausubel, Market Design Inc., dated January 23, 2004; Letter from Mohme@aol.com dated November 29, 2003; Letter from Lester Morse, Esq., Morse & Morse, PLLC dated January 15, 2004; Letter from Jed Bandes, Mutual Trust Co. of America Securities, dated November 28, 2003; Letter from Ralph A. Lambiase, NASAA, dated January 26, 2004; Letter from Mark G. Heesen, NVCA, dated January 16, 2004; Letter from Henry P. Williams, Oppenheimer & Co., Inc., dated January 9, 2004; Letter from Patricia Evans dated November 29, 2003; Letter from Paul N. Mullen dated November 28, 2003; Letter from Peggy Hutchinson dated November 29, 2003; Letter from Peter Locke dated November 28, 2003; Letter from RAMSkMgt@yahoo.com dated November 28, 2003;

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. 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.

Letter from Richard O. Gregory dated November 29, 2003; Letter from Rick Street dated November 29, 2003; Letter from Scott Cook dated January 23, 2004; Letter from John Faulkner, Securities Industry Association, dated January 23, 2004; Letter from Steve Antenozzi dated November 27, 2003; Letter from Thomas Weitzner dated November 30, 2003; Letter from Dr. Ann E. Sherman, University of Notre Dame, January 23, 2004; and Letter from William R. Hambrecht, WR Hambrecht & Co., dated January 9, 2004.

In Notice to Members 03-72, NASD solicited comment on a proposed rule change that would require that the underwriting agreement between the book-running lead manager and the issuer require that the book-running lead manager provide the issuer's pricing committee (or its board of directors if the issuer does not have a pricing committee) with: (1) a regular report of indications of interest, including the names of interested investors and the number of shares indicated by each, and (2) 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.

Commenters generally supported these requirements but suggested the following changes.

1. Institutional vs. Retail Disclosure

Some commenters suggested that the report of indications of interest and final allocations should relate only to the "institutional pot." Several commenters suggested that it is not practical for the book-running lead manager to provide the names of all individual investors who have expressed an indication of interest because the book-running lead manager does not collect the names of individual retail investors. Commenters also stated that brokerage firms consider the names of their individual investor clients to be proprietary information and confidentiality concerns may limit the ability of brokerage firms to disclose the names of individual investors to the book-running lead manager. Commenters also stated that retail indications of interest are usually submitted to a firm's syndicate desk as branch aggregates, not on an individual-by-individual basis. Finally, commenters suggested that information regarding the names

of individual investors is likely to be of limited use to an issuer because, in an IPO, there could be thousands of individual investors.

NASD staff agrees that disclosure of each retail customer's indications of interest (and subsequent allocations) would be of limited benefit to issuers and their pricing committees. The underlying purpose of this proposal is to ensure that the issuer or its pricing committees has a clear picture of the demand for its securities. Thus, information about each individual retail investor would generally not be helpful. Accordingly, the staff has revised the proposed rule change to require that the book-running lead manager disclose its institutional book of interest and to reflect retail demand in aggregate terms only.

2. Timing of Disclosure

One commenter suggested that rather than a "regular report" of indications of interest, the rule should require that the book-running lead manager provide information in a timely manner prior to pricing, or as frequently as requested by the issuer's pricing committee. Another commenter suggested that the book-running lead manager should be required to provide a single report of the major institutional indications of interest shortly before or at the time of pricing the offering.

The proposed rule would require a regular report of indications of interest, which report should be made as often as appropriate, including such as when a material change occurs, or in connection with certain meetings with the issuer or its pricing committee, and always as frequently as requested by an issuer or its pricing committee. Indeed, our understanding of the bookbuilding process is that most underwriters have frequent and

even daily discussions with issuers about the level of indications of interest. The proposed rule change thus would codify this practice.

In response to one commenter, however, NASD staff has amended the proposed rule change to require the book-running lead manager to provide the report on final allocations within a reasonable time after “settlement date” rather than after “closing date.” The settlement date and closing date can be the same date, but the term “settlement date” may be more precisely understood as the date on which the issuer transfers its shares in return for offering proceeds from the syndicate.

3. Additional Disclosure

One commenter suggested that issuers would benefit from receiving information regarding relationships that underwriters have with purchasers. This commenter suggested that issuers would benefit from receiving additional information regarding the intended holding periods of purchasers, since issuers generally favor allocations to long-term holders over “flippers.”

This information generally may be useful or relevant to issuers. As the specificity of information about past account activity increases, however, financial privacy concerns also increase. Brokerage customers may reasonably expect that their broker will keep particular information about trades they have made in their accounts confidential. In addition, SEC Regulation M prohibits underwriters during the bookbuilding process from attempting to induce purchases in the aftermarket. This limits some of the information the underwriters are permitted to obtain and provide to the issuer regarding whether any particular account will be buying or selling the securities in the aftermarket.

Accordingly, NASD staff has not included this requirement as part of the proposed rule change.

One commenter suggested that disclosure of different levels of interest at different prices should be required and that NASD should require a graphical display of this information. NASD staff believes that members should be able to design their forms of communication on indications of interest and final allocations as appropriate to particular offerings and issuers. Members, of course, may compete for investment banking business by offering certain disclosures and forms of disclosure, and likewise, issuers may condition an engagement with an investment bank on certain disclosures and forms of disclosure.

4. Underwriting Agreements

Several commenters stated that the obligation to provide indications of interest to the issuer should not be included in the underwriting agreement because the underwriting agreement is not signed until after pricing of the offering. These commenters suggested that NASD impose the obligation on the book-running lead manager directly. NASD staff agrees and has amended the proposed rule change accordingly.

b. Limitation on Market Orders for One Day Following an IPO

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. Commenters, such as the SIA, generally opposed this proposal. Some commenters suggested that educating retail investors about the

appropriate use of limit orders was the appropriate remedy. Commenters also stated that restricting investors only to limit orders on the first day of trading will artificially constrain trading activity and could impair the process by which a market price is determined.

NASD staff is not persuaded by the commenters that banning market orders for IPOs on the first trading day will have significant effects on liquidity or price discovery. Institutional investors rely almost exclusively on limit orders in the IPO aftermarket. NASD staff requests further comment on why the use of limit orders by retail investors will not allow markets to develop sufficient liquidity or become an effective tool for price discovery.

c. Returned Shares

The IPO Advisory Committee 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 might be a guaranteed profit to those customers. To address this concern, NASD solicited comment on a proposed rule change that would require underwriters first to allot returned shares to the existing syndicate short position. If there is no short position, or if the short position already has been covered by the time the shares are returned, the proposal would have permitted members to sell the remaining returned shares on the open market and return net profits to the issuer. The proposed rule change provided that if the market price does not rise above the offering price, then the underwriter would be

permitted to sell the shares at a loss for its account or retain the shares by placing them in its investment account.

Commenters and SEC staff raised concerns that the proposal's disposition of returned shares in the event that there is no existing short position may conflict with Regulation M. In response to these concerns, NASD staff has amended the proposed rule change to require that if no existing short position exists at the time that returned shares are received by a member firm, then the members must offer those shares to unfilled customers' orders at the public offering price pursuant to a random allocation methodology. While the proposed rule change does not specify a particular methodology, NASD staff expects that members will develop systems similar to those used to allocate options exercise notices.³ In general, these systems will require sequencing of all relevant accounts, assigning a sequence number to each account, and then generating a random number to identify where in the sequence to begin offering returned shares. In requiring the use of a random allocation methodology, NASD prevents members from being in a position to benefit by selecting a particular customer or group of customers to receive a guaranteed profit.

d. Limitations on "Friends and Family" Programs

The IPO Advisory 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. In Notice to Members 03-72, NASD solicited comment on a proposed rule change to require that any lock-up or restriction on the transfer of the issuer's shares also apply to issuer-directed shares held by officers and directors of the issuer. Commenters generally supported this proposal. One commenter

³ See Rule 2860(b)(23)(C).

believed that this proposal should be effected by a listing requirement rather than an NASD rule. NASD staff disagrees. Insofar as the lock-up agreement is a contractual arrangement between the underwriter and the issuer, we believe that imposing the requirement on the underwriter is appropriate.

e. 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 recommended that the lead underwriter announce any lock-up exemption through a major news service. NASD's proposed rule change would require that the underwriting agreement provide that 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.

Several commenters expressed concern that requiring the book-running lead manager to announce an impending release or waiver of a lock-up restriction on officers and directors would result in a large amount of meaningless information regarding sales of immaterial amounts of securities. NASD staff disagrees. Lock-up restrictions generally align the investment interest of the insiders subject to the lock-up with investors in the offering during the period of the lock-up. Investors should find notifications of a lock-up release or waiver to be important and relevant information.

Another commenter questioned whether this notification requirement was intended to apply to the release of the issuer, selling shareholder, or both. NASD's

proposed rule change will apply to a release or waiver of lock-ups by the issuer and any selling shareholder. While in many cases the release of an issuer will be followed by the filing of a registration statement before securities may be sold, that is not always the case (e.g., Rule 144A offerings). Accordingly, NASD staff has not proposed to exempt waiver of issuer lock-ups from the proposed rule change.

One commenter also suggested that the notice requirement should be subject to some materiality or de minimis exception and should apply only if the release relates to a sale into the market. This commenter suggested that the notification requirement should not apply to a release that allows only for minor sales or transfers of stock in which the transferee agrees to lock-up restrictions identical to those applicable to the transferor, such as transfers by a shareholder to a family trust or to a charity. NASD staff does not support this modification. NASD staff believes that investors expect that lock-ups will be applied for their stated term, and that even small sales may be material information. NASD staff also does not believe that there should be an exemption where the transferee agrees to identical lock-up restrictions. The fact that the shareholder or issuer no longer has accepted investment risk with regard to those securities is information that should be available to the market. In addition, if a transferee agrees to identical lock-up restrictions, any waiver or release of such restrictions as applied to such persons also must be preceded by a public announcement through a major news service.

A commenter suggested that the timing of the announcement should be based upon when a sale into the market may first take place, not when the release is to take place. Another commenter stated that two days' prior notice might not be sufficient. NASD staff believes that the timing of the announcement should be triggered by the

release date, not the eventual sale date, and that two days seems to be an acceptable period.⁴ In addition, if the waiver does not permit the immediate sale of securities into the market, then additional disclosure should be provided indicating when such sales may be permitted.

Finally, one commenter believed that disclosure by the issuer in Form 8-K would be sufficient. NASD disagrees. Form 8-K notification occurs after a sale has been made. NASD agrees with the IPO Advisory Committee that investors expect that lock-ups will be adhered to, and that they should be provided advance notice of any release or waiver.

f. Rulemaking Concerning the Pricing of Unseasoned Issuers

As discussed in Notice to Members 03-72, 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. NASD solicited comment on three possible approaches to the regulation of IPO pricing of unseasoned issuers. Unlike the other items in Notice to Members 03-72, these were presented as concepts only and NASD did not propose specific rule text.

The first proposal was a requirement for an underwriter to retain an independent broker-dealer to opine that the initial IPO range at which the offering is marketed and the final offering price are reasonable and require that the independent broker-dealer's opinion is disclosed in the prospectus. Commenters generally did not support this

⁴ Tying the period of prior notice to a particular market or the average trading volume, as suggested by one commenter, would, in NASD staff's view, be unnecessarily complex.

proposal. The most common criticism was that the proposal would impose considerable cost on issuers. Commenters added that the cost of the independent opinion would be especially burdensome on smaller issuers. One commenter believed that the cost for the opinion would be affected by the assumption of liability that would result from the requirement to disclose the independent opinion in the prospectus. Another commenter argued that the responsibility for recommending a public offering price should not be forced on another broker-dealer that is less involved in the offering process and likely to be less informed about the issuer and its securities. Several commenters noted that the independent broker-dealer rendering a pricing opinion would need to rely on information from the lead underwriter, or due diligence costs would be prohibitive. Finally, one commenter noted that issuers already have the ability to obtain independent pricing opinions from a second broker-dealer when they perceive a need for one.

In light of these concerns, NASD staff does not intend to propose a rule requiring an independent pricing opinion at this time.

The second proposal was to require the managing underwriter to use an auction or other system to collect indications of interest to help establish the final IPO price. Commenters expressed varying degrees of support for this proposal. Many commenters that appear to be individual investors supported implementation of the “Dutch Auction” though they offered little explanation. Other commenters opposed the adoption of any regulation that would require underwriters to use an auction approach to price setting. Several commenters stated that the market, and not regulators, should decide what pricing and allocation models are appropriate for particular IPOs. One commenter supported the development of alternatives to the bookbuilding process, but would not support the use of

an auction as the only alternative. Finally, one commenter stated that the auction method is impractical for small broker-dealers because they are not familiar with this pricing mechanism.

Recent developments have focused increased attention on the use of auctions, and it appears that more issuers and investment banks are using or considering the use of auctions to assist in pricing IPOs. Given these developments, NASD staff finds it premature to mandate use of auction systems.

The third proposal was to require the managing underwriter to 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 reviewing the issuer's one-year projected earnings or P/E ratios and share price information of comparable companies. Commenters expressed varied levels of support for this proposal. Some commenters strongly supported the proposed valuation disclosure requirement. One such commenter suggested that the valuation disclosure should be accompanied by an explicit fiduciary duty making underwriters accountable for their IPO pricing decisions. This commenter expressed concern that valuation rationales and earnings estimates generally are made available only to the institutional market through the book-running underwriter's research analyst, creating an "information monopoly" that is inaccessible to smaller institutions and retail investors. This commenter stated that the inclusion of earnings estimates in the prospectus is a very important step in allowing all investors to receive equal access to IPO pricing information in order for the lead underwriter to develop a complete and accurate demand curve.

Several commenters noted that the initial price range and final price reflect a large number of factors, including current market conditions. One commenter noted that pricing determinations are based not only on information about the issuer, its past results, current financials, and projected earnings, but also on information about market interest, performance of the stock market in the days preceding pricing, and the willingness of the issuer to accept a lower share price to sell into a down market. Some commenters noted that much pricing information, such as the selection of comparable companies is subjective. One commenter noted that projections of future earnings are one of many data points used by investors to determine the price and quantity of shares they are interested in purchasing. This commenter noted that the market ultimately determines price, and price may be driven by “market psychology” and other factors that are difficult to quantify.

Several commenters also expressed reservations about the valuation disclosure proposal because it would open the issuer and underwriter to future litigation if the projections were not met. Some commenters suggested that any proposal related to disclosure of issuer projections would need to be accompanied by a safe harbor to protect issuers and underwriters from liability in future litigation. These commenters generally favored expansion of the safe harbor under Section 27A of the Securities Act of 1933 to IPOs.

Some commenters suggested that the SEC, rather than NASD, should address the matter of valuation disclosure since it involves a disclosure requirement for issuers. One commenter added that the SEC also would be able to address the attendant liability concerns affecting issuers and underwriters.

Based on the comments received, NASD believes that the SEC is the more appropriate regulator to address the inclusion of projections. The SEC regulates the contents of a prospectus and also is in a position to address issues of liability.

g. Spinning

NASD staff also has made certain amendments to paragraph (b)(2) of the proposed rule change addressing spinning. In particular, NASD staff has expanded the prohibition to preclude allocations to executive officers or directors of a company if the member expects to receive or intends to seek investment banking business from the company in the next 6 months. Previously, the proposed rule change only looked forward 3 months.

In addition, the proposed rule change adds a presumption in paragraph (b)(2), stating that if a firm allocates IPO shares to an executive officer or director of a company and it subsequently receives investment banking business from that company, that the IPO allocations were made with the expectation or intent to receive such business. A member may rebut this presumption. Evidence to rebut this presumption could include procedures and information barriers that ensure that investment banking personnel involved in allocations do not have any information about the beneficial owners of retail accounts that received allocations.

The proposed rule change also eliminates the definition of immediate family and instead applies the prohibition on spinning just to persons “materially supported” by an executive officer or director of a company. This change narrows the scope of the spinning prohibition to include only those members of the immediate family that live in the same household as the executive officer or director and is similar in scope to the

provisions in Rule 2711 (Research Analysts and Research Reports). The definition, however, captures persons outside of an executive officer's or director's immediate family if such executive officer or director, directly or indirectly, provides more than 25% of the person's income in prior calendar year. This concept of material support is the same as used in Rule 2790 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings).

(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 Notice to Members 03-72 as discussed in Section II(A)(1) above.

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, including whether the proposed rule change [as amended] is consistent with the act. 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. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. SR-NASD-2003-140. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. 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