NASD AMENDS PROPOSED RULE RELATING TO INITIAL PUBLIC OFFERING (IPO) ALLOCATIONS AND DISTRIBUTIONS

DECEMBER 8, 2003

On September 15, 2003, the National Association of Securities Dealers, Inc. filed proposed NASD Rule 2712 with the Securities and Exchange Commission to prohibit certain abuses in the allocation and distribution of shares in IPOs.[1] On November 24, 2003, the NASD proposed amendments to proposed Rule 2712 (the "Proposed Amendments") to address recommendations of the NYSE/NASD IPO Advisory Committee (the "IPO Advisory Committee").[2] The IPO Advisory Committee was established in October 2002 in response to an SEC request to convene a high-level group of business and academic leaders to review the IPO process, to recommend ways to address problems that surfaced during the market of the late-1990s, and to improve the underwriting process.

The Proposed Amendments respond to a number of the recommendations of the IPO Advisory Committee and would:

- require the lead managing underwriter to disclose indications of interest and final allocations to the issuer's pricing committee;
- prohibit acceptance of market orders to purchase IPO shares in the aftermarket for one trading day following an IPO;
- impose procedures designed to ensure that reneged IPO allocations are not used to benefit favored clients of the underwriter;
- require that any lock-up that applies to shares owned by the issuer's officers and directors also applies to shares they purchase in "friends and family" programs; and
- impose new notification requirements when underwriters waive lock-ups.

In addition to the Proposed Amendments, the NASD Notice to Members also solicits comment on additional proposed regulatory steps that are intended to promote "transparency" in IPO pricing.

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1 File No. SR-NASD-2003-140 (Sept. 15, 2003).

2 NASD Notice to Members 03-72 (November 2003).

Statutory and Regulatory Background

Rule 2712 as originally proposed addressed a variety of perceived abuses in the allocation and distribution of shares in IPOs.

- Proposed Rule 2712(a) would expressly prohibit an NASD 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 prohibition of *quid pro quo* allocations would prohibit this activity not only with respect to trading services, but also to any service offered by the member.

- Proposed Rule 2712(b) would prohibit the allocation of IPO shares to an executive officer or director of a company, or to the immediate family of such executive officer or director ("spinning"), if the NASD member had received compensation from the company for investment banking services in the past 12 months. The proposed rule also would prohibit such allocations if the member expects to receive or intends to seek compensation from the company for investment banking services in the next three months. In addition, the proposed rule would prohibit such allocations to the extent made on the condition that the executive officer or director, on behalf of the company, direct future investment banking business to the member.[3]

- Proposed Rule 2712(c) would prohibit NASD 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 Rule 101 of SEC Regulation M, 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."

The SEC has not completed its review of the proposed Rule 2712. The Proposed Amendments supplement the proposed Rule 2712 but do not in any way alter the terms summarized above.

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[3] The language of these provisions is based on similar language in NASD Rule 2711 concerning disclosure of investment banking compensation in research reports.

Proposed Amendments

Disclosure of Indications of Interest and Final Allocations. Proposed Amendments to NASD's proposed rule would require that IPO underwriting agreements include provisions requiring the book-running manager(s) to provide to the issuer's pricing committee (or, if the issuer has no pricing committee, its board of directors) a regular report of indications of interest, including the names of interested investors and the number of shares indicated by each. In addition, provisions would need to be included in the underwriting agreement requiring that the book-running lead manager(s) provide the issuer's pricing committee (or, if the issuer has no pricing committee, its board of directors) with a report of the final allocation of shares available to the manager(s), including the names of purchasers and the number of shares purchased by each purchaser after the closing date of the IPO.[4]

Limitations on "Friends and Family" Programs. The Proposed Amendments to the NASD's proposed rule would require that IPO underwriting agreements contain provisions requiring that any lock-up or restriction on the transfer of the issuer's shares apply to issuer-directed shares held by officers and directors of the issuer.

Requirements Concerning Lock-Up Exemptions. The Proposed Amendments to the NASD's proposed rule would also require that IPO underwriting agreements contain provisions requiring underwriters to notify the issuer before granting a lock-up waiver or release and announce the waiver or release through a national news service. The IPO Advisory Committee also recommended that before granting any waiver to a lock-up, underwriters should be required to notify the issuer and the issuer should be required to file a Form 8-K with the SEC describing the exemption. Such an additional requirement would necessitate SEC rulemaking and is not covered by the NASD's proposed rules.

Trading Restrictions. The Proposed Amendments to the NASD's proposed rule would prohibit any member from accepting a market order to purchase IPO shares during the first trading day that the IPO shares commence trading in the secondary market. Investors would remain free to place limit orders during this period. By disallowing market orders for the first trading day following an IPO, the IPO Advisory Committee reasoned that the market will have time to develop trading information, thereby making subsequent uncapped orders less likely to cause harm to retail investors.

The Proposed Amendments to the NASD's proposed rule would also require that provisions be included in agreements among underwriters used in IPOs that would require underwriters to allot returned shares to the existing syndicate short position, then sell the remaining returned shares on a national securities exchange or Nasdaq and, if the sales price

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[4] The NASD has requested comment on whether disclosure of other information to issuers also would be useful. For example, the NASD has elicited comment on whether issuers should receive other specified information about the managing underwriters' pricing analysis or allocation decisions.

exceeds the IPO price, to pay to the issuer such difference. When the market price does not rise above the IPO price, the underwriter would be permitted to sell the shares for its account or retain the shares by placing them in its investment account. This proposal is designed to eliminate the practice whereby underwriters allocate returned shares to favored customers at the IPO price, thereby providing what amounted to a risk-free investment to favored customers.

Comment Sought on Other IPO Rulemaking

The NASD is considering three possible approaches to foster "transparency" in IPO pricing.[5] These approaches would require the managing underwriter to:

- retain an independent broker/dealer to opine that the initial IPO price range at which the offering is marketed and the final offering price are reasonable and to require that the independent broker/dealer's opinion is disclosed in the prospectus; or

- use an auction or other system to collect indications of interest to help establish the final IPO price; or

- include a "valuation disclosure" section in the prospectus with information about how the managing underwriter and issuer arrived at the initial price range and final IPO price, such as the issuer's one-year projected earnings or P/E ratios and share price information for comparable companies.

The NASD has requested comment on these potential approaches, which are identified as alternative approaches. In soliciting comments, the NASD queries whether the reforms should be adopted for the IPOs of all issuers or only "unseasoned" issuers, itself a term/concept

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

- the IPO Advisory Committee recommended that regulators review existing rules and practices in order to promote the development of alternatives to the book-building process. In particular, the IPO Advisory Committee was interested in whether regulators could take any steps to foster development of the "Dutch Auction" system of price discovery.

- the IPO Advisory Committee considered, but did not propose, a requirement that a prospectus provide an estimate of projected earnings in certain cases. Investment banks often provide projected earnings information to institutional investors, and this information is viewed as critical to the determination by institutional investors of whether IPO shares are fairly priced.

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

on which the NASD has invited comment. Finally, the NASD asked commenters to address the additional risk placed on the issuer and underwriters by the independent pricing opinion and valuation disclosure proposals. Before requiring issuers and underwriters to assume additional liability by including this information in IPO prospectuses, the NASD solicits comments as to whether it would be appropriate for the SEC to consider rulemaking to provide issuers and underwriters with a safe harbor from liability.[6]

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This memorandum is for general informational purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, *www.simpsonthacher.com*.

SIMPSON THACHER & BARTLETT LLP

[6] Rule 175 under the Securities Act of 1933 (the "Securities Act") provides a safe harbor for projections that have a "reasonable basis" and are "made in good faith". Many issuers do not provide earning projections under Rule 175 because of the litigation risk that is associated with these limitations. Section 27A of the Securities Act authorizes the SEC to provide a safe harbor that requires actual knowledge that a forward-looking statement is false before it becomes actionable. Currently, Section 27A does not apply to IPOs. If the alternatives discussed above concerning an independent pricing opinion or valuation disclosure reforms are pursued, the NASD may recommend that the SEC extend Section 27A to cover IPOs.