



NASD Proposes New IPO Allocation and Distribution Rules

Introduction

NASD Regulation, Inc. ("NASDR"), the regulatory arm of the National Association of Securities Dealers, Inc. (the "NASD"), has issued Notice to Members 02-55 (the "Notice"),¹ proposing new Rule 2712, "IPO Allocations and Distribution" ("Rule 2712", or the "Proposed Rule"), and proposing to amend Rule 2710 (the "Corporate Financing Rule").

The current proposals are the direct result of the substantial media coverage of the initial public offering ("IPO") allocation practices of NASD member firms (each, a "Member") during the bull market of the late 1990s, and seek to address certain practices, including offering shares in an IPO as consideration for excessive brokerage fees, or tying IPO allocations to purchases in the aftermarket.

In making these proposals, NASDR is careful to note that existing securities laws, such as Rule 10b-5 and Regulation M, and existing NASD Rules, such as Rule 2110 (Standards of Commercial Honor and Principles of Trade) and the Corporate Financing Rule, already prohibit certain IPO allocation abuses. Members should not, therefore, interpret this release as an acknowledgment by NASDR that the activities covered by the Notice are not covered by existing securities laws or by the NASD's existing Conduct Rules.

In short, the Notice proposes the following new regulation:

- *Compensation for Allocations.* A prohibition on offering or threatening to withhold certain allocations of IPO shares as consideration for receipt of compensation that is excessive in relation to the services provided by the Member;
- *Aftermarket tie-ins.* A prohibition on NASD Members who request that a customer purchase

shares in the aftermarket as a condition to the allocation of IPO shares;

- *Past or Future Business.* A prohibition on the allocation of IPO shares to an executive officer or director of a company as an inducement for future investment banking business, or as consideration for past investment banking business;
- *Flipping.* A prohibition on any penalty on persons associated with a Member² whose customers have "flipped" IPO shares, unless similar penalties have been imposed on the Member by the managing underwriter; and
- *Allocations to Executives and Directors.* A reporting requirement under the Corporate Financing Rule that would require NASD Members to report to the NASD detailed information regarding the receipt by any executive officer or director of any IPO shares from the "book-running managing underwriter" within 180 days before the distribution under review, or within 180 days after the effective date of the offering under review.

Finally, Rule 2712 would require that each NASD Member adopt and implement written procedures designed to ensure compliance with the Proposed Rule.

NASDR initially requested comments by September 9, 2002, but has now extended that period to September 23, 2002.

Regulations regarding IPO allocations, purchases in the aftermarket, "spinning" and "flipping"

Compensation for Allocation

The Proposed Rule places an outright prohibition on the offer of (or threat to withhold) IPO shares as con-

¹ The Notice can be found at www.nasdr.com/pdf-text/0255ntm.pdf

² "Person associated with a member" is defined in Article I of the By-Laws of the NASD, and includes registered representatives of a Member.

sideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the Member.

NASDR provides little guidance on what would constitute “excessive” compensation and specifically requests comment on this provision. NASDR does, however, specifically state that Rule 2712 would not be intended to prohibit a Member from allocating IPO shares to a customer because that customer has separately retained the Member for other services, provided that the compensation received by the Member in connection with those services was not itself excessive.

Aftermarket tie-ins

The Proposed Rule prohibits any request by a Member or person associated with a Member that a customer purchase shares in the aftermarket as a condition to being allocated shares in a distribution of IPO shares.

In the Notice, NASDR notes that such “aftermarket tie-ins” are currently prohibited by Rules 101 and 102 of Regulation M and, as such, the Proposed Rule would supplement that existing regulation.

Past or Future Business

Rule 2712 would prohibit any allocation of IPO shares to an executive officer or director of a company either (a) on the condition that such person direct future investment banking business (on behalf of the company) to the Member, or (b) as consideration for having previously directed investment banking services to the Member from the company.

NASDR states that the practice of directing business in exchange for IPO shares, or “spinning”, divides the loyalties of the officer or director from his or her principal (the company), and is therefore inconsistent with just and equitable principles of trade. In making that assertion, NASDR is effectively taking the position that “spinning” is a violation of (existing) Rule 2110.

NASDR states, however, that this provision is not intended to prohibit a Member from allocating IPO shares to a person “merely because the customer is an executive officer or director of a company.”

Flipping

The Proposed Rule prohibits any direct or indirect financial penalty on registered representatives whose retail customers “flip” IPO securities by selling them within 30 days of the effective date of that IPO. The Proposed Rule places a prohibition on recouping, or attempting 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 for selling the shares to a customer that engaged in flipping, unless the managing underwriter has assessed a penalty bid on the Member.

This prohibition is meant to ensure that retail customers are not pressured to retain long positions in IPO shares unless institutional customers are so penalized. A penalty could be assessed on an associated person if a Penalty Bid (as defined in Regulation M) were imposed by the managing underwriter on the syndicate member in the offering.

Regulation regarding allocating IPO shares to directors and officers of an issuer

In addition to the Proposed Rule’s prohibition on aftermarket tie-ins, the Notice proposes a significant change to the Corporate Financing Rule.

The Proposed Rule requires Members to file certain information with the NASD in connection with every public offering reviewed by the Corporate Financing Department.³ Specifically, the Proposed Rule requires that, as part of each filing reviewed by the Corporate Financing Department, Members disclose whether any executive officer or director of the issuer acquired from the book-running managing underwriter of the public offering any shares in any IPO during the 180-day period immediately preceding the filing date of the offering. Similarly, where any executive officer or director of the issuer purchases or acquires from the book-running managing underwriter any shares in any IPO within 180 calendar days after the effective date of the issuer’s offering, that too must be disclosed to the NASD.

Where an executive officer or director of an issuer has received shares of any IPO during the periods in question, the Member must disclose for each such officer or director:

- the name of the executive officer or director;
- 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
- whether the executive officer or director participated in any capacity in the selection of the

³ On a plain reading of the text of the Proposed Rule, it appears that offerings that are exempt from filing pursuant to NASD Rule 2710(b)(7), or exempt from the Corporate Financing Rule pursuant to NASD Rule 2710(b)(8), would be exempt from these disclosure requirements.

book-running managing underwriter for the issuer's public offering.

Two elements of these proposed changes are noteworthy. First, the information required by the proposed changes to the Corporate Financing Rule operate in addition to the existing Corporate Financing and "Hot Issue" Rules, including those proposed amendments to the Corporate Financing Rule that are currently enforced by the Corporate Financing Department of NASDR.⁴ Second, the proposed changes to the Corporate Financing Rule present specific and detailed circumstances under which a filing with the Corporate Financing Department with regard to an offering must be updated within 180 days after the effective date of that offering.

The proposed change to Rule 2710 represents a significant compliance requirement relative to current practice. If the proposed changes to Rule 2710 are adopted in their current form, Members should ensure that their existing procedures are adjusted to alert compliance officers when allocations of any IPO shares are made to officers or directors of public companies.

Requirement to adopt supervisory procedures

Finally, each Member subject to the Proposed Rule must adopt and implement written procedures reasonably designed to ensure that the Member and its employees comply with the provisions of Rule 2712. Imposing a requirement to adopt written procedures in light of rule changes is a common practice of the NASD.

Conclusions

It is our view that the NASD will seek to quickly implement the Proposed Rule and the proposed changes to the Corporate Financing Rule discussed in the Notice. While in some cases this will not require substantial changes to Members' existing compliance procedures, Members will be required to inform various employees and other associated persons of the nature of the prohibited activities, and will be required to implement systems to ensure that certain transactions are reported within the Member firm and to the NASD.

⁴ Certain proposed changes to the Corporate Financing Rule have been enforced by NASDR since first proposed in January of 2000 on the grounds that such changes are interpretations of the existing Rule 2710. The text of these proposed changes is available from Shearman & Sterling, or at http://www.nasdr.com/filings/rf00_04.asp.

If you require a detailed analysis of the consequences of the Proposed Rule, or if you would like to discuss any of the issues covered in this memorandum, please contact any of the following people:

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