NASD Reissues Proposed Rule Governing IPO Allocations and Distributions

INTRODUCTION
On September 15, 2003, the National Association of Securities Dealers (“NASD”) filed with the Securities and Exchange Commission (the “SEC”) a revised proposal regarding allocations and distributions of initial public offerings (“IPOs”) by NASD members. The purpose of proposed Conduct Rule 27121 (the “Proposed Rule”) is to expressly prohibit certain abuses that can occur in the allocation and distribution of IPO securities. In the Rule Filing, the NASD notes that although the NASD continues to propose new rules relating to the allocation and distribution of IPO securities, existing federal securities laws and NASD rules apply to the allocation and distribution of IPO and other securities by broker-dealers. Various NASD rules2 and high-profile enforcement actions3 underscore this point. On November 24, 2003, the NASD published Notice to Members 03-72 (“NTM 03-72”), which proposed additional amendments to the Proposed Rule.

The Proposed Rule modifies an existing proposal relating to IPO allocation and distribution.4 Generally speaking, the Proposed Rule amends the proposals found in NTM 02-55 in order to take into account various comments received by the NASD from the joint NASD-New York Stock Exchange committee (the “Advisory Committee”) relating to the IPO process, which was convened in August of 2002 and which issued its report in May 2003.5

Executive Summary of Proposed Rule 2712
Proposed Rule 2712 contains four basic prohibitions:

- Quid pro quo allocations. A prohibition on the offer to allocate, or threat to withhold allocation of, IPO securities in exchange for the receipt of compensation that is excessive in relation to the services provided to the customer by the NASD member.

- Spinning. A prohibition on the allocation of IPO securities to executive officers and directors of a company if, in the 12-month period prior to the allocation (or in the three-month period following the allocation), the broker-dealer received (or will

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1 The Proposed Rule and the NASD’s discussion thereof (the “Rule Filing”) is currently available on the NASD Internet website at <http://www.nasdr.com/pdf-text/rf03_140.pdf>. The Proposed Rule is one of a number of NASD rules that affect the distribution of securities by NASD members, in the capacity as underwriter or otherwise.

2 Two prominent examples of NASD rules affecting the distribution of securities by NASD members include Rules 2710 and 2720 (commonly known as the “Corporate Financing Rules”) and Rule 2790, relating to new issue securities. For more information regarding the Corporate Financing Rules, see “Proposed Rule Changes to NASD Conduct Rule 2710 Substantially Alter Existing Practice”, currently available at <http://www.shearman.com/documents/CM_09_10_03.pdf>. For more information regarding Rule 2790, see “NASD Rule 2790 Revises Restrictions on the Purchase and Sale of Initial Equity Public Offerings”, currently available at <http://www.shearman.com/documents/AM_10_11_03.pdf>. In addition, new NASD and NYSE regulations in relation to research analyst conflicts of interest impose quiet periods on NASD members engaging in distributions of securities. For more information regarding these recent regulations relating to research activities of U.S.-registered broker-dealers, see “SEC Approves Changes to NASD and NYSE Rules Relating to Research Analyst Conflicts of Interest”, currently available at <http://www.shearman.com/documents/SD_08_03.pdf>.

3 The NASD has in the recent past taken enforcement actions in connection with IPO allocation issues, such as that taken in respect of alleged “spinning” by former Credit Suisse First Boston investment banker Frank Quattrone in March 2003: the NASD’s press release regarding this action is currently available at <http://www.nasdr.com/news/pr2003/release_03_010.html>.


receive) compensation for investment banking services from the company.

- **Flipping.** A prohibition on penalizing registered representatives of a NASD member whose customers have “flipped” IPO securities unless a penalty bid has been imposed on the NASD member by the managing underwriter in connection with the distribution of the IPO securities.

- **Acceptance of First-day Market Orders.** A prohibition on any NASD member accepting a market order for the purchase of IPO shares during the first day that such shares commence trading on the secondary market.

In addition, the Proposed Rule contains the following requirements that will be imposed on NASD members in respect of the pricing of IPOs:

- **Underwriting Agreement Provisions.** Under the Proposed Rule, the underwriting agreement must provide that the lead-managing underwriter will transmit to the issuer a regular report of indications of interest, and, after the closing date of the IPO, a report of the final allocation of shares. As well, the underwriting agreement must provide that any transfer restrictions on transfer of the issuer’s shares held at the time of the IPO by directors and officers of the issuer will apply to any issuer-directed shares. Finally, the underwriting agreement must state that the lead manager of the IPO will publicly announce (and notify the issuer of) any release or waiver of any transfer restrictions on IPO shares.

- **Agreement Among Underwriters.** Under the Proposed Rule, the agreement among syndicate members must provide that shares returned by a purchaser to a syndicate member after trading commences will be allotted to the syndicate short position, or, if no short position exists, will be sold on a national securities exchange (or through NASDAQ), with any surplus over the IPO price being paid to the issuer.

These provisions of the Proposed Rule are described in detail below.

**Details of Proposed Rule 2712**

**Prohibition on “Quid Pro Quo” Allocations**

Proposed Rule 2712(a) would prevent so-called “quid pro quo” allocations of IPO securities by NASD members engaged in the distribution of IPO securities. The text of proposed Rule 2712 reads as follows:

“No member or person associated with a member may offer or threaten to withhold shares it allocates in an initial public offering…as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the member.”

This section of the Proposed Rule attempts to prevent the use of IPO allocations as leverage for the receipt of excessive compensation from a customer. The NASD notes in the Rule Filing that the provision prohibits the use of “quid pro quo” IPO allocations with respect to any service provided by the NASD member, and not just with respect to the receipt of compensation in the form of commissions paid by a customer. However, the prohibition found in Proposed Rule 2712(a) is not intended to interfere with bona fide relationships between a NASD member and its customer. For example, the Rule Filing specifically states that the Proposed Rule is not meant to “prohibit a member from allocating IPO shares to a customer because the customer has separately retained the member for other services, when the customer has not paid excessive compensation in relation to those services.”

**Prohibitions on “Spinning”**

The Proposed Rule prevents NASD members or persons associated with NASD members from allocating IPO securities to an executive officer or director of a company, or to the immediate family of such an executive officer or director: (a) if that NASD member has received compensation from the company for investment banking services in the 12 months prior to the IPO distribution, (b) if the member expects to receive or intends to seek compensation from the company for investment banking services in the three months following the IPO distribution, or (c) on the condition that the officer or director, on behalf of the company, direct future investment banking business to that NASD member.

The Rule Filing notes that “spinning”, the practice of awarding IPO securities to senior personnel of investment banking clients in exchange for past business or in exchange for the explicit or implicit promise of future business, divides the loyalty of a company’s senior personnel from their principal.

The NASD also notes that “spinning” is “inconsistent

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6 See the Rule Filing at page 6.
7 See Proposed Rule 2712(b).
8 See the Rule Filing at page 7.
with the just and equitable principles of trade." It should be noted that the NASD, in proposing Proposed Rule 2712(b) in relation to “spinning”, has modified NTM 02-55 in two important ways: first, Proposed Rule 2712(b) applies not only to executive officers and directors of companies with which the NASD member has an investment banking relationship, but also to the “immediate family” of such persons. Second, on the recommendation of the Advisory Committee, the Proposed Rule has been modified to seek to bar IPO allocation to all executive officers and directors of a company with which the NASD member has an investment banking relationship. The Rule Filing notes that an appearance of impropriety may arise due to the very existence of the investment banking relationship.

Compliance with the Proposed Rule will require rigorous attention to the identities of the recipients of any IPO securities.

“Flipping”

Under the Proposed Rule, no NASD member or associated person of that NASD member may directly or indirectly recover, or attempt to recover, any portion of a commission 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 member seeking to recover such commissions. As well, the Proposed Rule expands on the NASD member’s record-keeping requirements in connection with penalty bids, and NASD members will be required to record and maintain information regarding any penalties or disincentives assessed on its associated persons in connection with a penalty bid. While the NASD states in the Rule Filing that it does not oppose the use of penalty bids, it notes that the recovery of commissions from registered representatives may cause retail customer to be pressured to retain positions in IPO securities, while institutional investors are rarely pressured in this way.

Underwriting Agreement Provisions

NTM 03-72 suggests further amendments to the Proposed Rule that are meant to implement several of the recommendations of the Advisory Committee. Specifically, Proposed Rule 2712 would be amended to include a provision that no NASD member may serve as lead manager in an IPO unless the underwriting agreement provides that the lead manager will provide the issuer with a regular report of indications of interest, including the names of interested investors and the number of shares indicated by each. After the closing date of the IPO, the lead manager must provide to the issuer a report of the final allocation of shares in the IPO.

In addition, the underwriting agreement must provide that any lock-up or other transfer restrictions placed on an issuer’s shares held at the time of the IPO by officers and directors of the issuer must also apply to issuer-directed shares held by the issuer’s directors and officers.
Finally, the Proposed Rule would require that, at least two business days before the release or waiver of any transfer restrictions on any of the issuer’s shares, the lead manager must (a) notify the issuer of the pending release or waiver, and (b) publicly announce the pending release or waiver through a “national news service”.17

Agreement Among Underwriters

Proposed Rule 2712 contains a requirement18 that any agreement among underwriters must provide that any shares returned to any syndicate member after the commencement of secondary market trading will be allotted to the syndicate short position, if any. If no syndicate short position exists, or if all of the syndicate’s short positions have been covered, then the returned shares must be sold on a national securities exchange (or through NASDAQ). However, in the event of such a sale, the excess of the sale price over the IPO price (if any) must be paid to the issuer. If the market price at the time of the proposed sale is lower than the IPO price, then the NASD member may either (a) sell the shares on a national market (or through NASDAQ), or (b) retain the shares in its investment account.

The purpose of this requirement is to eliminate the possibility that any shares returned to the underwriter(s) after the commencement of secondary trading will be allocated to favored customers at the IPO price.

Prohibition on Execution of Market Orders During the First Day of Trading

The Advisory Committee recommended a prohibition on executing market orders for one trading day following an IPO. This recommendation was based on the conclusion that the volatility of IPO securities is such that investors who purchase IPO securities very close in time to the completion of the initial public offering risk purchasing or selling at a price that does not reflect the “true investment decisions” or the “reasonable expectations” of the investor.19 Consequently, Proposed Rule 2712(e)(3) provides that no NASD member may accept a market order for the purchase of an IPO security during the first day that such security commences trading on the secondary market.

17 No definition of this term is given. However, NTM 03-72 also refers to this requirement as a requirement to publicize the pending release or waiver of transfer restrictions as a “major news service.”

18 See Proposed Rule 2712(e)(2).

19 See NTM 03-72 at page 772.

NASD Requests Further Comment Regarding Various Issues Relating to IPO Allocation and Distribution

In addition to publishing additional amendments to Rule 2712, NTM 03-72 requests comment on additional rulemaking concerning the pricing of IPOs. Specifically, the NASD has requested comments as to:

• Whether alternatives to the “book-building process”, such as a “Dutch auction” system of price discovery, should be promoted.

• Whether approaches to confirming the pricing of IPO securities, such as the retention of an independent broker-dealer, the use of an auction system, or the inclusion of “valuation disclosure” in the prospectus is required.

• Whether regulatory initiatives relating to pricing of IPOs should apply to all IPOs, or only to “unseasoned” issuers, and by what standards such seasoning should be measured.

• Whether rulemaking in respect of pricing of IPOs that requires particular valuations (e.g., an independent pricing opinion) or particular disclosures (e.g., projected earnings) should also be accompanied by a safe harbor protecting issuers and/or underwriters from liability for such valuations or disclosures.

Conclusion

The Proposed Rule, when viewed in connection with the comprehensive amendments proposed to the NASD’s Corporate Financing Rule 2710 and the recent adoption by the SEC of NASD Rule 2790 relating to the allocation and distribution of “new issue” securities, represents the latest chapter in an active period of rulemaking by the NASD with respect to the corporate financing activities of NASD members. Concurrently, the NASD and the SEC have been active in review of allocation and distribution activities of U.S.-registered broker-dealers, and have brought substantial enforcement actions in this regard. As market conditions continue to improve and corporate financing activities increase in number and size, NASD members must continue to be cognizant of this changing terrain in order to avoid violations of the NASD’s complex web of new standards in relation to public distributions of securities. For more information regarding the specific issues covered by this publication, please feel free to contact any of the Shearman & Sterling LLP attorneys listed below.
This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

Charles S. Gittleman  
New York, New York  
(+1 212) 848-7317  
cgittleman@shearman.com

Russell D. Sacks  
New York, New York  
(+1 212) 848-7585  
rsacks@shearman.com

www.shearman.com