MEMO# 18391

January 12, 2005

NYSE AND NASD PROPOSE RULE CHANGES RELATING TO IPOS

[18391] January 12, 2005 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 3-05 SEC RULES MEMBERS No. 6-05 RE: NYSE AND NASD PROPOSE RULE CHANGES RELATING TO IPOS The Securities and Exchange Commission has published for comment proposed rules filed by the New York Stock Exchange and the National Association of Securities Dealers governing the allocation and distribution of initial public offerings.1 Similar to the Commission's proposed amendments to Regulation M,2 the proposed rules would prohibit certain inappropriate conduct in allocating and distributing IPOs in order to provide investors with a greater degree of confidence in the IPO process and the capital markets as a whole. The most significant aspects of the proposed rules are summarized below. Quid Pro Quo Allocations The proposed rules would prohibit members and member organizations from allocating IPO shares as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the member or member organizations. According to the Release, the proposed prohibition is not intended to interfere with a member's or member organization's business relationships with its customers nor would it prohibit legitimate allocations of such IPO shares to customers, even when a customer has retained the member or member organization for services. Spinning The proposed rules would prohibit the practice of "spinning," which is the awarding of IPO shares to executive officers and directors of a company, including a person "materially 1 Securities Exchange Act Release No. 50896 (Dec. 20, 2004), 69 Fed. Reg. 77804 (Dec. 28, 2004) ("Release"). The Release can be found on the Commission's website at http://www.sec.gov/rules/sro/nyse/34-50896.pdf. Comments on the proposed rules are due to the Commission no later than January 18, 2005. 2 For a summary of the Commission's proposed amendments to Regulation M, see Institute Memorandum to Equity Markets Advisory Committee No. 53-04 and SEC Rules Members No. 177-04, dated December 22, 2004 [18342]. 2 supported"3 by such executive officer or director, if the member or member organization (1) has received compensation from the company for investment banking services in the past 12 months; (2) expects to receive or intends to seek investment banking business from the company in the next six 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 or member organization. The proposed rules include a rebuttal presumption 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, the IPO allocations were made with the expectation or intent to receive such business. Penalty Bids The proposed rules would prohibit the inequitable imposition of a penalty bid4 on associated persons whose customers flipped IPO shares, unless the penalty is imposed on the entire syndicate. In

addition, the rules would require member and member organizations to maintain records of penalty bids in accordance with the Securities Exchange Act of 1934. IPO Pricing and Trading Practices In an effort to promote greater transparency in IPO pricing, the proposed rules would require the book-running lead manager of an IPO to disclose in a regular report indications of interest and final allocations of interest of an IPO to an issuer's pricing committee or, if the issuer has no pricing committee, to its board of directors or a managing group authorized to oversee the process. The proposed rules would require prior notification through a major news service when "lock-up agreements" for shares expire or are waived. According to the Release, this notification requirement will benefit an issuer's shareholders and the marketplace because it will ensure that they are aware of this information prior to and not after the sale by directors and officers of the issuer. The Release notes that IPO shares are sometimes returned to the underwriter after secondary trading commences as a result of either: (1) mistaken allocations; or (2) incomplete information or other problems relating to the delivery of shares and settlement of trades. In instances where the IPO shares trade at an immediate aftermarket premium, the underwriter has the ability to allocate any returned shares to favored customers at the IPO price, guaranteeing such customers an immediate profit. In response to this practice, the proposed rules would require all syndicate members to prioritize the treatment of returned shares in the following order: (1) use the returned shares to offset any existing syndicate short position; or (2) if no syndicate short position exists, or if all existing syndicate short positions have been 3 The proposed rules define "materially support" to mean directly or indirectly providing more than 25 percent of a person's income in the prior calendar year. In addition, persons living in the same household are deemed to be providing each other with material support. 4 Penalty bids are a means by which the managing underwriter may impose a financial penalty on syndicate members whose customers sell offering shares in the immediate aftermarket, i.e., "flipping." 3 covered, offer those shares to customers' unfilled orders at the public offering price pursuant to a random allocation methodology. Finally, the proposed rules would prohibit the acceptance of market orders to purchase IPO shares in the aftermarket for one trading day following an IPO. The Release notes that IPOs are more volatile than stocks with a public trading history and the placement of market orders by individuals in the immediate aftermarket may not reflect their true investment decisions or their reasonable expectations. The Release also notes that institutional investors generally rely on limit orders for IPOs in the aftermarket and as a result, the NYSE and the NASD do not believe that the prohibitions on the placement of market orders for IPOs on the first trading day will have an appreciable effect on liquidity and market efficiency. Proposed Amendments to Regulation M The Release states that the Commission requests comment on any differences between the proposed amendments to Regulation M and the NYSE and NASD proposed rules. Specifically, the proposed amendments to Regulation M include a proposal to prohibit penalty bids altogether, whereas the NYSE and NASD proposals are based on the continued use of penalty bids. Jane G. Heinrichs Assistant Counsel

---