Securities Industry Association
120 Broadway, New York, NY 10271-0080 • (212) 608-1500, Fax (212) 608-1604 • info@sia.com, www.sia.com

January 23, 2004

Barbara Z. Sweeney
NASD
Office of Corporate Secretary
1735 K Street, N.W.
Washington, D.C. 20006-1500

Re: Notice to Members 03-72; Proposed Rule Governing Allocations and Distributions of Shares in Initial Public Offerings

Dear Ms. Sweeney,

The Capital Markets Committee of the Securities Industry Association ("SIA") is pleased to submit this response to the above-referenced Notice to Members (the "Notice"). We support the efforts of the NASD to address specific issues of concern in connection with the Initial Public Offering ("IPO") process and are very much committed to the fundamental goals behind the proposed rules. The rule proposals follow up on recommendations included in the Report of the NYSE/NASD IPO Advisory Committee (" IPO Report"), which SIA praised when it was released in May of 2003. While suggesting specific targeted reforms, the report also recognized that our capital raising system is the most successful in the world and is the engine for our country's economic growth, enabling companies to raise the capital they need to expand.

For the most part, we believe that the specific rulemaking proposals included in the Notice offer useful suggestions to further the objective of enhancing public confidence in the integrity of the IPO process. We do, however, have substantive concerns about certain aspects of the proposals as drafted, and we discuss those concerns below as well as ideas on how the rules can better serve issuers and investors. We also have serious concerns about some of the concepts discussed in the section of the Notice requesting comment on "potential regulatory initiatives."

We begin with a few general comments on IPO Pricing and follow with our comments on the specific rulemaking proposals included in the Notice. We conclude with our comments on the "potential regulatory initiatives" section.

GENERAL COMMENTS

The purpose of the recent NASD amendments that appear in the Notice is to enhance the transparency of the IPO pricing process. Clearly, price swings in the early days of trading for many IPOs during the late 1990's were nothing short of dramatic. First day gains in the prices of many new companies led some market commentators to conclude that these companies had been *undervalued*. Later, the dramatic market-wide price decline that accompanied increased competition, the end of a major technology spending cycle, and the waning of investor enthusiasm for "new economy" companies, led many of the same observers to conclude that these same companies had been *overvalued*. Obviously, both views cannot be correct, and in fact, the suggestion that there is an objectively correct price, or that additional regulation will help underwriters and the public find it, is both flawed and dangerous.[1]

The reason is that there is no precise formula for pricing an IPO. Pricing takes into account some objective factors, like a company's historical financial performance, but also considers subjective factors, like the expectations investors have for the future growth of the particular company, its sector and the overall markets. In the absence of an existing market for the stock, which would normally operate to reflect investor expectations of future growth, it falls upon the underwriter to interpret these expectations as best as possible in working with the issuer to set the IPO price.

An understanding that price is inherently subjective is necessary for a fair and realistic evaluation of what these proposals are intended to accomplish. The fact that underwriters and issuers freely negotiate price in an arms length transaction and are usually assisted in the valuation process by other experts, should leave no doubt as to the integrity and basic fairness of the ultimate price that is agreed upon. Finally, it bears a reminder that underwriters assume the financial risk for the shares they underwrite and by virtue of their experience in distributing new securities into the market, help determine the price that will best balance the interests of investors and issuers, and ensure the integrity of the capital markets.

SPECIFIC RULEMAKING PROPOSALS

Proposed Rule 2712(e)(1) and (2) - Provisions of Underwriting Agreement and AAU

Sections (e)(1) and (e)(2) of the proposed rule would require the Underwriting Agreement and Agreement Among Underwriters for an IPO to include certain provisions.

[1] The IPO Report noted the same conflicting views of over- vs. under-pricing among those parties that made presentations to the panel. IPO Report at FN 5.

The approach of using these agreements strikes us as unnecessarily indirect. These underwriting agreements are contracts negotiated among the parties to a transaction. There is no reason to create rules that would seem to require the use of particular types of contracts in the IPO context. If, for example, a single underwriting firm were to underwrite an IPO, there would be no AAU (there is no group of underwriters, so there is no need for a contract governing their interactions). It is unclear how a member firm could comply with the proposed rules in this circumstance. In all events, these contracts typically require underwriters to comply with applicable law.

We believe that the rules should instead be phrased as direct requirements applicable to member firms when they are participating as underwriters in SEC-registered IPOs. The references to the underwriting agreement and AAU should be deleted. Direct rules will operate as effectively as rules in the form proposed in the Notice, and direct rules avoid any unintended contractual consequences.

Proposed Rule 2712(e)(1)(A) - Disclosing Indications of Interest to Issuer

Indications of Interest

SIA supports the provision requiring the book-running lead manager to report to the issuer on indications of interest in the book, but believes the report should relate only to "institutional pot" demand.

The proposal would require the report to include "the names of interested investors and the number of shares indicated by each." It is not clear whether this is intended to include the names of individual investors as well as institutional investors. It is also not clear whether this is intended to include indications received by all syndicate members or just the book-running lead manager. It is a longstanding practice for the lead manager to provide the issuer with the names of institutional investors that have indicated an interest in the deal. It is not typical, nor is it practical, for the lead manager to provide the names of individual investors who have indicated an interest. Book-runners do not collect the names of individual investors from syndicate members or from their own retail systems.

There are a number of reasons why it is not practical for the book-running lead manager to gather individual investor names to provide to the issuer. Brokerage firms consider the names of their individual investor clients to be proprietary information, and will not want to share that information with the bookrunner. In addition, retail indications of interest are usually submitted to a firm's syndicate desk as branch aggregates, not on an individual-by-individual basis. Also, privacy considerations may limit the ability of brokerage firms to disclose the names of individual investors to the bookrunner. Agreements with retail clients often include confidentiality or privacy terms that restrict the sharing of personal financial information concerning customer accounts.

Finally, it is also worth noting that information regarding the names of individual investors who have indicated an interest in a transaction is likely to be of limited or no value to an issuer. In an IPO, there could be thousands or even tens of thousands of such investors, and only aggregate information about total demand is really of use to the issuer in making its price determination.

There are also policy reasons for limiting the names included in the proposed report to those of institutional investors. In response to concerns about "spinning," many securities firms have taken steps in recent years to ensure that investment bankers do not become involved in individual investor allocation decisions. Indeed, the Voluntary Initiative, an undertaking signed in April 2003 by ten large securities firms and federal and state regulators, prohibits investment banking personnel from having input into IPO allocations to individual investors. Investment bankers necessarily become involved in nearly all communications between underwriting firms and their issuer clients, and are generally the point of contact for issues or concerns that arise in the course of the banking relationship. A requirement that underwriters provide IPO issuers with the names of interested individual investors could draw bankers close to allocation decision - making and consequently, at odds with the objectives of the Voluntary Initiative and other measures designed to address concerns about "spinning."

For all of these reasons, SIA recommends requiring disclosure to the issuer of the names of interested investors and the number of shares indicated by each only with respect to institutional pot demand. With respect to all other investors, disclosure to the issuer should be presented in an aggregate format and should not include individual names and share amounts.

Regular Reports

Section (e)(1)(A)(i) of the proposed rule would also require the lead manager of an IPO to provide the issuer with "a regular report" of indications of interest. It is not clear what frequency of reporting is contemplated by the term "regular report." It is also not clear that multiple reports would necessarily be of use to issuers. The bookbuilding process is highly dynamic. Indications of interest change continuously, and indications are generally less reliable early in the marketing process than they are just prior to pricing. We note in this regard that the Notice says that it is intended to implement recommendations of the NYSE/NASD IPO Advisory Committee. The Advisory Committee, in its recommendation regarding indications of interest, suggests that the underwriter should provide the issuer with information about indications "in a timely manner" before pricing, but does not suggest that there should be "regular" reports.

The timing of these communications ought to be left flexible to ensure that it does not require delivery of information that is unreliable or that the issuer would prefer not to receive. Rather than a "regular" report, the rule should require the book runner to

provide information in a timely manner prior to pricing, or as frequently as requested by the issuer's pricing committee.

Proposed Rule 2712(e)(1)(A) - Disclosing Final Allocations to Issuer

Many of the same considerations that apply to information about individual investor indications of interest also apply to information about final allocations to individual investors. These include privacy and confidentiality considerations, as well as concerns about the proprietary nature of each underwriter's list of individual investor accounts. In light of these considerations, current practice is for each syndicate member to bill and deliver its own retail allocations. Thus, SIA recommends that any report of final allocations should include the names of investors only with respect to institutional pot purchasers. With respect to all other investors, disclosure to the issuer should be presented in an aggregate format.

The appropriate time for member firms to provide the report on final allocations is within a reasonable period of time after the settlement date. To clarify this point, the term "closing date" should be replaced with the term "settlement date" in the rule.

Proposed Rule 2712(e)(1)(B) - Lock-up Restrictions

SIA supports the provision requiring that any lock-up on the transfer of shares by officers and directors of the issuer must also apply to their issuer-directed shares.

Proposed Rule 2712(e)(1)(C) - Notification of Lock-up Release

This provision would require the underwriting agreements to establish that the book running lead manager will notify the issuer of a release or waiver of a lock-up and publicly announce the impending release or waiver at least two days before the release or waiver.

SIA has a fundamental question whether this provision applies to a release of the issuer or the selling shareholders, or both. If it is intended to apply to the issuer, SIA sees no reason for a public announcement of the release when the sale requires the filing of a registration statement since the market would already learn of the release by virtue of the issuer's filing. A public announcement would only be necessary in the case of an issuer who has an effective shelf registration statement and intends to use the shelf to effect a sale. If the rule is intended to apply to shareholders selling into the market, then the timing of the announcement should be based on when a sale into the market may first take place, not when the release is to take place.

To illustrate this point, consider a release letter signed on January 1 that provides that the released shares may be sold at any time on or after January 5, but not prior to that time. In this circumstance, it should not be necessary to provide notice to the market two business days prior to January 1. Notice two business days prior to January 5 should satisfy the rule. Similarly, if a release letter is signed that allows only for the filing of a registration statement relating to locked-up shares, but does not allow for the sale of any such shares, no notice to the market should be necessary. The NASD should also ensure that the proposed rule is consistent with NASD Rule 2711(f)(4) and related NYSE Rule 472(f), which also address lock-up releases.

To address these points, we suggest that the language in (e)(1)(C) be revised to read as follows: "At least two business days before any sale may take place resulting from a release or waiver of any lock-up or other restriction on the transfer of the issuer's shares by a control person other than the issuer." We are concerned that without this change, the rule might require notice of waivers that cannot result in any actual sale of shares and, thus, an announcement may actually confuse the market.

As a general matter, the obligation to provide notice to the market through a national news service should attach to the issuer. Under our disclosure-based system, it is the issuer, not any third party, which has the obligation to inform the market of material developments relating to the company's stock. Moreover, issuers are better equipped than syndicate desks to prepare the notice and work with a national news service.

We also believe that the notice requirement should be subject to some materiality or de minimis exception and should apply only to lock-up releases that will result in a sale into the market. In many cases, lock-ups are released for purposes of relatively minor sales or transfers of stock, for example by a shareholder to a family trust or to a charity, and the transferee agrees to lock-up restrictions identical to those applicable to the transferor. To avoid inundating the market with large numbers of inconsequential notices that might obscure the notices that really matter, the notice requirement should apply only if the release relates to a sale by the issuer or a sale into the market of a large number of shares by someone whose decision to sell is important to the market (e.g., a control person).

Proposed Rule 2712(e)(2) - Returned Shares

SIA supports the provision requiring the specific disposition of shares returned by a purchaser to a syndicate member after secondary trading commences. SIA agrees with the goal of eliminating any opportunity for abuse that may arise as a result of holding returned shares after the share price has already traded higher. However, the proposal relating to returned shares should be changed slightly in order to tailor the rule more

narrowly to the potential abuse and to preserve the issuer's ability to achieve greater proceeds through exercise of the over-allotment option if conditions are favorable.

The NASD should narrow the scope of the proposed rule to address only situations where there is a gain on the shares – in other words, where the stock is trading above the IPO price. If there is a loss, the potential abuse that the proposed rule is intended to address is not implicated and there is no reason for the rule to impose changes on existing market practice (which may, for example, include transferring the shares into an error account and bearing the cost of the loss, or, selling the shares out of the customer's account and charging the customer for the amount of the loss). As the IPO Report and the discussion in the Notice state, the abuse that raised concern is the awarding of appreciated returned shares to favored customers. SIA is concerned that a rule focused on returned shares that trade lower will give investors the impression that it is acceptable to walk away from a transaction when shares trade down in the immediate aftermarket. All of section (e)(2)(d) of the proposal should be deleted and the lead-in to this section should include language limiting its applicability to shares trading at a price that exceeds the IPO price.

In addition, SIA recommends modifying the list of alternatives that apply when there is a gain on returned shares as follows: returned shares should first be applied to any naked short position of the syndicate. Once the naked short position has been reduced to zero, the underwriters should have the option, with respect to any returned shares, to either (1) sell the shares into the market and pay the difference between the sale price and the IPO price to the issuer, or, (2) offset the shares against the syndicate short. By narrowing the scope of short positions that must be satisfied with returned shares, the rule increases the chances of the issuer benefiting from both the exercise of the "greenshoe" and the proceeds of returned shares.

Proposed Rule 2712(e)(3) - Prohibition on Market Orders

SIA agrees that retail investors should be educated about the pros and cons of placing a market order versus a limit order during the first day of trading after IPO pricing. However, we believe that the proposal needs to be revised to address unintended consequences and the special needs of the institutional trading market.

It is only when a new issue begins trading that the forces of supply and demand, in the form of buy and sell orders, begin operating to determine a market price for the stock. The emergence of a trading market for a new security can be marked by volatility as broad buy and sell interest comes together to determine a market price. Regulators have long recognized the importance of liquidity in the early aftermarket to the success of an offering since liquid markets tend to be good for the long-term viability of the issuing company and also minimize risks to investors.

Restricting investors to only 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. Such restrictions could also impair liquidity in the market for these shares. Limit orders do not execute until the order's limit price is reached. Natural liquidity for a new market must come from market orders, which are immediately executable against other market and limit orders. This result would be contrary to the long-standing goal of ensuring liquidity for the new shares. Moreover, the restriction may have the effect of postponing, until the second day of trading, the emergence of a true liquid market that brings together all buyer and seller valuations of the new shares.

During the bubble, there were investors who, desperate to receive shares in the new company, would submit a market order, only to later discover that they had received an execution at a price significantly higher than was reasonable to assume they would ever pay. While firms are eager to protect investors from the vagaries of hot markets, this regulation will not help investors to help themselves. Surely, a public policy goal of regulation ought to be to encourage investors to investigate price before investing, just as any consumer ought to know to check the price of something before purchasing it. Thus, SIA recommends improvements to required disclosure so that investors understand the uses of market and limit orders, and the potential volatility of the market for some period of time on the first day of trading, depending on the stock and then current market conditions.

However, if the NASD determines that limits need to be imposed on the use of market orders, SIA has concerns about how the rule would operate in practice. To be effective, the rule needs to apply to all member firms, not just those that happen to be underwriters of an IPO. (In fact, evidence suggests that many of the individual investor market order trades executed in the immediate aftermarket during the IPO bubble were placed with firms that were not underwriters.) This is the approach that the NASD has taken in its proposal, and we agree with this approach. But this raises a question: How will firms that are not involved in an IPO know that a particular stock is in its first day of post-IPO trading? If a market order for a newly public stock is received by a broker at a retail branch office of a firm that has not been involved in the IPO, it is not clear how the broker, or the firm, could possibly know whether the stock has just begun trading or has been trading for more than a day.

Obviously, there would need to be some system for identifying newly priced IPOs prior to the commencement of trading in the IPO stock. Effective implementation of the rule would then likely require use of a systems block prior to the opening of the market on the first day of trading.

POTENTIAL REGULATORY INITIATIVES

In addition to the specific rule language proposed in the Notice, the NASD invites comment on three possible additional approaches to addressing the issue of fair and reasonable pricing of IPOs. The three possibilities are an auction approach to price setting, an independent pricing opinion and a valuation disclosure section in prospectuses. The Notice invites comment as to whether the concepts discussed should be adopted only for IPOs of unseasoned issuers or for all IPOs. It also invites comment as to how seasoning should be measured and suggests that a "seasoned" issuer could be defined as an issuer with at least three years of revenues, operating revenues or net income.

Valuation Disclosure

SIA has reservations about requiring a valuation disclosure section in the IPO prospectus, but believes that aspects of the proposal should be explored further. For the purpose of helping investors come to their own conclusions about a company's value, SIA believes that disclosure of additional information may prove very useful.

Our principal objection to the concept as proposed is that it would require disclosure that links the issuer's earnings projections to the IPO filing range and final offering price. The Notice does this by describing the "valuation disclosure" section as containing information, including issuer projections, "about how the managing underwriter and issuer arrived at the initial price range and final IPO price." Projections of future earnings are one of many data points used by investors to determine at what price and in what quantity they are interested in purchasing shares. But while projections are useful to valuation analysis, they do not provide a formula for determining price. As noted below under "Independent Pricing Opinion," the market ultimately determines price, and price may be driven by market psychology and other factors that are difficult to quantify. Disclosure rules should not require that earnings projections be presented in a way that suggests a formulaic linkage to price. For this reason, we do not support the idea of a "valuation disclosure" section.

Despite our objection to the concept of a "valuation disclosure" section, we believe that aspects of this proposal may be deserving of further exploration. In particular, one thing that might prove useful to investors is information from the issuer about earnings expectations. Clearly, issuers are increasingly eager to share earnings guidance, particularly in the context of follow-on offerings. For their part, investors may want such numbers to plug into their own valuation models. The IPO Report noted that several members of the Committee would recommend requiring issuer projection information to be included in the prospectus, provided there is a statutory safe harbor to address liability concerns. This idea has also been actively discussed in recent years as a

part of the effort to revise the rules governing communications under the Securities Act of 1933. Any proposal relating to disclosure of issuer projections should be thoroughly discussed with the issuer community, investors, the securities industry and the securities bar before action is taken. And, as the Advisory Committee report suggests, there would need to be a safe harbor for issuers and underwriters. SIA suggests that the NASD defer to the SEC on this matter since regulatory action should take the form of a prospectus disclosure requirement for SEC-registered issuers.

Auction Approach

The Notice requests comment on whether underwriters should be required to use an auction system to collect indications of interest. We note as a preliminary matter that the Notice states that it is intended to implement recommendations of the IPO Advisory Committee. The SIA has been very supportive of the work of the Advisory Committee and generally agrees with its recommendations. The Notice occasionally departs from or otherwise does not accurately reflect the Advisory Committee recommendations. This is particularly true in the "potential regulatory initiatives" section. We believe that in a number of cases these deviations from the recommendations made by the Advisory Committee create serious flaws in the NASD's proposals.

One important example is the discussion in the Notice of the auction approach to price setting. The Notice states "the IPO Advisory Committee recommended that regulators review existing rules and practices in order to promote the development of alternatives to the bookbuilding process" (emphasis added). The Notice goes on to say that the Advisory Committee "was interested in whether regulators could take any steps to foster development of the "Dutch Auction" system of price discovery."

In fact, there is no language in the report of the IPO Advisory Committee recommending that regulators "promote" any particular price setting model. The report clearly recommends that regulators steer clear of any such efforts, saying in relevant part "the market, and not regulators, should determine whether bookbuilding, a Dutch Auction or another method is desirable for a particular IPO."[2] Moreover, far from recommending proactive efforts to promote the auction approach to price setting, the report only recommends that regulators should "review their rules with a view to addressing provisions that may impede the use of such alternative pricing methods."[3]

SIA supports the position taken by the Advisory Committee in its report. Regulatory impediments to alternative approaches to price setting should be removed. But regulators should not take steps to promote certain pricing and allocation models.

---

[2] IPO Report, Recommendation #8, p. 9.
[3] Id.

The market, and not regulators, should decide what method is best for any particular IPO. We urge the NASD to correct its statement that the Advisory Committee recommended that regulators promote alternatives to bookbuilding and modify its proposals accordingly. And we oppose adoption of any regulation that would require underwriters to use an auction approach to price setting.

Independent Pricing Opinion

The Notice also requests comment on whether underwriters should be required to retain an independent broker/dealer to opine that the initial IPO price range and the final offering price are "reasonable." The opinion would be disclosed in the prospectus.

SIA is opposed to this idea, whether or not it is limited to situations where the issuer is "unseasoned." We believe it would add considerable cost to the IPO process with little meaningful benefit to issuers or investors.

The idea is flawed in that it assumes that there is such a thing as an objectively "reasonable" price for a new security. While some measure of value can be determined by reference to the assets of a company and its past performance and future prospects, it is an axiom of capital raising that "the market" (i.e., the subjective valuations of a large number of investors, each deciding for itself independently) ultimately determines price. Moreover, the proposal fails to specify whether reasonableness is to be measured from the perspective of the issuer or investors or both. What is reasonable to one investor may not be reasonable to all investors. What is reasonable to all investors may not be reasonable to an issuer. Indeed, the current process is designed to produce a price that balances the different views and interests of the issuer and investors.

Even if it were possible for someone to deliver such an opinion, it would be incredibly costly to obtain. In today's system, underwriters, accountants, and attorneys all contribute to the process of determining the financial condition of a company, which is an important factor in determining price. This proposal would essentially require duplication, by an independent broker-dealer, of all efforts undertaken by these parties in reviewing information about the company. This would significantly add to the cost of the underwriting to the issuer. And if the opinion will have to be disclosed in the IPO prospectus – subjecting the independent broker-dealer to potential prospectus liability on the reasonableness of the IPO price – the fee for the opinion will be even higher. Questions regarding the liability of those providing the opinion and the extent of the due diligence required for a defense would have to be resolved.

CONCLUSION

We applaud the NASD for its efforts to implement the recommendations of the IPO Advisory Committee. The specific rules proposed in the notice relating to price transparency, combined with the NASD's existing proposals to ensure that underwriters avoid unacceptable conduct when they allocate IPOs, offer useful suggestions to further the objective of enhancing public trust in the integrity of the IPO process. New capital from an IPO is what allows companies to invest in new equipment, expand operations, hire more employees, and otherwise grow their business for the benefit of shareholders. The preeminent method for raising capital in this country is book building, by which underwriters attempt to build a book of potential orders from investors to complete the public distribution of shares before they begin trading in the public market. This system has worked remarkably well. While other systems for raising capital – auction, subscription, pro-rata allocation - have been tried in other markets, none has been as successful or popular as book-building. As markets will undoubtedly continue to behave in a cyclical manner, it is critical to remember that U.S. capital markets remain the envy of the world and are the world's most efficient and transparent. The tendency to want to "manage" market ups and downs should not be allowed to undermine confidence in America's time-tested and world-leading capital raising system.

We would be happy to meet with you at your earliest convenience to discuss our views or answer any questions. Please contact Scott Kursman, SIA Vice President and Associate General Counsel (212-618-0508), if you would like to set up a meeting with the Committee. Thank you again for the opportunity to comment.

Very truly yours,

John Faulkner,
Chairman, SIA Capital Markets Committee

Cc: Mary Schapiro
Marc Menchel
Elisse Walter
Thomas M. Selman
Joseph E. Price
Gary L. Goldsholle