



**NASAA**

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**NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.**

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January 26, 2004

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

Via e-mail to [pubcom@nasd.com](mailto:pubcom@nasd.com)

Re: NASD Notice to Members 03-72- Request for Comment  
Proposed Rule Governing Allocations and Distributions of Shares in IPOs

Dear Ms. Sweeney:

The North American Securities Administrators Association, Inc. (NASAA)<sup>1</sup> appreciates the opportunity to comment on NASD Notice to Members (NtM) 03-72, *Proposed Rule Governing Allocations and Distributions of Shares in Initial Public Offerings (IPOs)*. Our comments supplement those we made on September 25, 2002, in response to NASD NtM 02-55, also concerning the regulation of IPO allocations and distributions.

In August 2002, the SEC directed the NASD and NYSE to form an IPO Advisory Committee (hereinafter "Committee") for the purpose of proposing solutions to problems evidenced in hot-market IPOs since 1999. NtM 03-72 would supplement NASD Rule 2790, approved by the Securities and Exchange Commission (SEC) in October of 2003 (SR-NASD-2003-140). The present proposal would amend NASD Rule 2712 to address a number of the 20 recommendations made by the IPO Advisory Committee.

NASAA generally supports the proposals made by the Committee and contained in NtM 03-72. The proposal would provide specific guidelines to the industry that go beyond those that now exist. "Spinning," "tie-ins," and "flipping" already are violations of state and federal law. The new measures crafted by the Committee create practical tools that underwriters, issuers, and others can apply to the IPO allocation system to ensure compliance.

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<sup>1</sup> The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

## **1. PROPOSED AMENDMENTS TO RULE 2712**

NASAA supports the proposals aimed at eliminating IPO allocation abuses. This goal is furthered by additional transparency in the allocation of shares and the operation of lock-ups and through restrictions on sale policies and practices that hurt IPO investors or reward only investors that may provide other business to the underwriter. We offer the comments below on selected portions of the proposal.

NASAA strongly endorses the recommendation of the IPO Advisory Committee that issuers be required to establish a pricing committee. We understand that a requirement that issuers establish such a committee would necessitate a new listing standard by both the Nasdaq Stock Market and the NYSE.

### **a. Disclosure of Indications of Interest and Final Allocations**

NASAA agrees that issuers should have more information regarding indications of interest and the final allocations of the issuer's shares in an IPO. Transparency of this process to the board and management of an issuer enables management to fulfill its fiduciary duties to investors. Transparency also provides information critical for evaluating the performance of the underwriters. To the extent that an issuer's lead or co-underwriter maintains a "friend or family" program, information regarding an underwriter's allocation of shares into its own program should be provided to the issuer's pricing committee.

### **b. Trading Restrictions**

With respect to the prohibition on market orders for one trading day, NASAA appreciates the IPO Committee's rationale of giving the market time to develop trading information, thereby making market orders less likely to cause harm to investors. We recognize the potential that interfering in the capital markets in such a way could lead to artificially driven pricing, rather than prices derived from efficiency of the markets. If this aspect of the proposal is implemented, it may be advisable to conduct a market study as to the effects of the trading restriction on the marketplace.

We also question how retail investors will be educated about the restriction on market orders. The same market study also should look at the impact of the restriction on these investors.

### **c. Unallocated Shares**

NASAA applauds the IPO Committee for noting the problems inherent when an underwriter allocates returned shares to favored customers at the IPO price when an IPO's share trades at an immediate aftermarket premium. This is a gift, not an investment. In fact, state securities regulators uncovered instances of such conduct in their recent inquiries into investment analyst conflicts of interests. We concur with the recommendation that underwriters allot returned shares to the existing syndicate short position, then sell the remaining returned shares on the open market and return net profits to the issuer. When the market price does not rise above the offering price, the underwriter should be permitted to sell the shares for its account or retain the shares by placing them in its investment accounts.

#### **d. “Friends and Family” Programs**

The term “issuer directed” shares should be clearly defined in the rule text. Furthermore, consistent with sound principles of corporate governance, there must be a paper trail for the issuer’s Board of Directors regarding the basis for distribution of all “friends and family” shares, whether by the issuer or underwriter.

As noted above, NASAA appreciates the concern expressed by the IPO Committee regarding the need to ensure that returned IPO allocations are not used to benefit favored clients of the underwriter. This is particularly true when the underwriter knows that the IPO is “hot” and the allocation is, in reality, a reward tied to unrelated business. Underwriter friend and family programs merit tremendous scrutiny because of the potential for unfairness to other investors. We suggest that this is a matter that should receive additional comment from the IPO Committee, including a requirement that the aggregate number of shares reserved for issuer-directed and underwriter friend and family programs be identified in the offering prospectus.

#### **e. Requirements Concerning Lock-up Exemptions**

Releasing shares from a lock-up imposed in an IPO rarely benefits the issuer, and therefore, rarely benefits investors as a whole. It benefits individual stockholders – usually control persons – and it benefits underwriters. This IPO mechanism has had an unsavory side in the recent past, particularly with micro-cap issuers. The industry standard has been to bury disclosure related to lock-up agreements in the prospectus, with a liberal dose of boilerplate generalities.

NASAA has adopted provisions in its Statements of Policy expressly requiring that shares of promoters, management, and control persons be subject to lock-ups.<sup>2</sup> “Merit” review jurisdictions routinely require such lock-ups, and “disclosure” review jurisdictions routinely issue comments in an attempt to untangle the related descriptions. These conditions should not be used as advertising gimmicks during the waiting period. When the prospectus discloses a lock-up, all parties should be held to the bargain, and any material change should be publicized at a reasonable time *in advance* of the release of the lock-up.

While we support the lock-up provisions of the proposal, it is not clear whether two days’ prior notice for the release or waiver of a lock-up is sufficient to effectuate the purpose of the notice. Providing investors not connected with management an opportunity to act upon pending sales by management, family, and friends may require more than two days. The period could be tied to either the market/exchange in which the shares trade, or the average trading volume for the issuer’s shares. Or, the advance notice period might be tied to the volume or percentage ownership of the insider shares to be sold.

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<sup>2</sup> As a condition of securities registration, “merit” states that apply the NASAA Statement of Policy Regarding Promotional Shares require promoters to “lock-up” shares for which they paid, in the aggregate, less than 85% of the public offering price for a finite period of time. Sales of promoters’ shares may depress the current market value of the shares and cause a devaluation of the shares bought by public investors, at the same time, providing a significant profit to the promoters who paid substantially less than the public offering price for their shares. Additionally, the lock-up agreement ties officers and directors to the company for the lock-up period, reducing the possibility that management will abandon the company immediately following the public offering.

## **2. ADDITIONAL PROPOSALS**

We support the NASD's concern that additional regulatory action may be needed to better understand the forces behind volatile price movements in IPO trading, such as those in the late 1990s and 2000. NtM 03-72 also solicits comments on alternate proposals such as pricing through "Dutch auctions," requirements for independent opinions, or additional pricing disclosures.

### **a. Dutch Auctions**

NASAA supports the concept of a "Dutch auction" pricing process. Further, NASAA concurs with the IPO Committee's recommendation that encourages regulators to determine if additional steps can be taken to "...foster development of the 'Dutch Auction' system of price discovery".

### **b. Independent Pricing**

We appreciate the position of the IPO Committee in seeking to promote fair pricing that would benefit investors.

NASAA believes the inclusion of a "valuation disclosure" section in the prospectus could provide a fairer result to investors. When share price information of comparable companies is included in the prospectus, the methodology used to determine which companies are comparable should be described. We also recommend that the IPO Committee give consideration to establishing standards for further identifying the comparables. That would provide more guidance to issuers and result in more uniform disclosure.

NASAA believes an independent pricing opinion may add a risk and an expense out of proportion to the benefit. Opinions always add the potential for added liability, and added cost. Adding "independence" requirements also introduces regulation and disclosure of the attendant conflicts.

The NASD invited comment as to whether reforms should be adopted for the IPOs of all issuers or specifically for IPOs of "unseasoned issuers." In many "hot" offerings, there have been business operations for a number of years and the issuers have performance records that led to the IPOs being considered highly desirable. NASAA believes that pricing information requirements should apply to all IPOs.

The NASD poses the question, should the safe harbor provisions of Section 27A of the Securities Act apply to IPOs if the independent pricing opinion or valuation disclosure reforms were required under NASD rules. NASAA has previously stated herein that it does not believe that the independent pricing approach is viable; therefore the safe harbor provision should not be applied.

Secondly, with regard to IPOs using "valuation disclosure," NASAA believes that the safe harbor provision afforded under Section 27A is not warranted. It is our view that valuation disclosure amounts to nothing more than discussing the methodology used in valuing the IPO.

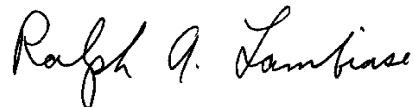
## CONCLUSION

State securities regulators have a long history of working with NASD to assure the fairness and transparent operation of the brokerage and investment banking industries. The investing public will benefit from extending fairness and transparency to the IPO allocation and distribution process.

NASAA particularly appreciates the work of the IPO Advisory Committee. To the extent we or other commenting parties raise issues that require further evaluation, we encourage the continuation of the Committee for such purposes.

Should you have questions about NASAA's comments, please feel free to contact Tanya Solov, Chair of the NASAA Broker-Dealer Section and Director of the Illinois Securities Department or Denise Voigt Crawford, Chair of the NASAA Corporation Finance Section and Texas Securities Commissioner. NASAA also wishes to recognize the contributions of Matthew Neubert, Arizona Director of Securities, and Timothy Cox, Assistant Attorney General and Chief of Securities Registration for the Maryland Division of Securities.

Sincerely,

A handwritten signature in cursive script that reads "Ralph A. Lambiase".

Ralph A. Lambiase  
NASAA President and  
Director, Connecticut Division of Securities