Paper Comments

• Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File Number SR–DTC–2004–11. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of DTC and on DTC's Web site at *http://www.dtc.org.* All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–DTC–2004–11 and should be submitted on or before January 18, 2005.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[8]

Margaret H. McFarland,

Deputy Secretary.

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[8] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–50896; File Nos. SR–NYSE–2004–12; SR–NASD–2003–140]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Changes by the New York Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in Initial Public Offerings (''IPOs'')

December 20, 2004.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Exchange Act'')[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on September 10, 2004, the New York Stock Exchange, Inc. (''NYSE'' or ''Exchange'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') Amendment No. 1 to its proposed rule change (''NYSE Amendment No. 1''), which it originally filed on February 25, 2004.

On August 4, 2004, the National Association of Securities Dealers, Inc. (''NASD'') filed with the Commission Amendment No. 2 to its proposed rule change (''NASD Amendment No. 2''), which it originally filed on September 15, 2003, and subsequently amended on December 9, 2003.

NYSE Amendment No. 1 and NASD Amendment No. 2 are described in Items I, II, and III below, which Items have been prepared by the respective self-regulatory organizations (''SROs''). The Commission is publishing this notice to solicit comments on the proposed rule changes as amended from interested persons.

I. Self-Regulatory Organizations' Statements of the Terms of Substance of the Proposed Rule Changes

The NYSE is filing with the Commission proposed new NYSE Rule 470 (IPO Allocations and Distributions), governing the allocation and distribution of initial public offerings (''IPOs'').

NASD is proposing new NASD Rule 2712 to further and more specifically prohibit certain abuses in the allocation and distribution of shares in IPOs.

Below is the text of the proposed rule changes. Proposed new language is underlined.

A. NYSE's Proposed Rule Text

Rule 470 IPO Allocations and Distributions

Prohibition on Abusive IPO Allocation Practices

(A) Quid Pro Quo Allocations

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

(B) Spinning

No member, member organization, or person associated with a member or member organization may allocate IPO shares to an executive officer or director of a company, including to a person materially supported by such executive officer or director:

(1) if the member or member organization has received compensation from the company for investment banking services in the past 12 months;

(2) if the member or member organization expects to receive or intends to seek investment banking business from the company in the next 6 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.

For purposes of Rule 470(B)(2), a member or member organization that allocates IPO shares to an executive officer or director of a company, or a person materially supported by such officer or director, from which it subsequently receives investment banking business within the next 6 months, will be presumed to have made the allocation with the expectation or intent to receive such business. A member or member organization, however, may rebut this presumption by demonstrating that the allocation of IPO shares was not made with the expectation or intent to receive investment banking business.

(C) Policies Concerning Flipping

(1) No member, member organization or person associated with a member or member organization may directly or indirectly recoup, or attempt to recoup, any portion of a commission or credit paid or 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, as defined in Rule 100 of Regulation M under the Securities Exchange Act of 1934 (the ''Exchange Act''), on the entire syndicate.

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b-4.

(2) In addition to its obligation to maintain records relating to penalty bids under Rule 17a–2(c)(1) of the Exchange Act, a member or member organization shall promptly record and maintain information regarding any penalties or disincentives assessed on its associated persons in connection with a penalty bid.

IPO Pricing and Trading Practices

(D) IPO Pricing

No member or member organization may serve as a book-running lead manager of an IPO, unless the IPO meets all of the following conditions:

(1) The book-running lead manager will provide the issuer's pricing committee (or, if the issuer has no pricing committee, its board of directors) or a similar managing group authorized to oversee and address the pricing and allocation of such IPO shares:

(a) a regular report of indications of interest, including the names of interested institutional investors and the number of shares indicated by each, as reflected in the book-running lead manager's book of potential institutional orders, and a report of aggregate demand from retail investors;

(b) after the settlement date of the IPO, a report of the final allocation of shares to institutional investors as reflected in the books and records of the book-running lead manager, including the names of purchasers and the number of shares purchased by each, and aggregate sales to retail investors.

(2) Lock-Up Agreements. Any lock-up agreement or other restriction on the transfer of the issuer's shares by officers and directors of the issuer shall provide that:

(a) such agreements will apply to their issuer-directed shares;

(b) at least two business days before the release or waiver of any lock-up or other restriction on the transfer of the issuer's shares, the book-running lead manager will notify the issuer of the impending release or waiver and announce the impending release or waiver through a major news service.

(3) Agreement Among Underwriters. The agreement between the book-running lead manager and other syndicate members provides that with respect to any shares returned by a purchaser to a syndicate member after secondary market trading commences:

(a) the returned shares will be used to offset any existing syndicate short position; or

(b) if no syndicate short position exists, or if all existing syndicate short positions have been covered, the member or member organization must offer returned shares at the public offering price to customers' unfilled orders pursuant to a random allocation methodology.

(E) Market Orders

No member or member organization may accept a market order for the purchase of IPO shares during the first day that IPO shares commence trading on the secondary market.

(F) Definitions

For purposes of this Rule, the following terms shall have the meanings stated below.

(1) The terms ''person associated with a member or member organization'' and ''associated person of a member or member organization'' shall have the same meaning as defined under Section 3(a)(21) of the Exchange Act.

(2) The term ''initial public offering'' is defined in Rule 472.100.

(3) ''Material support'' means directly or indirectly providing more than 25% of a person's income in the prior calendar year. Persons living in the same household are deemed to be providing each other with material support.

(4) The term ''investment banking services'' is defined in Rule 472.20.

(5) ''Flipped'' means the initial sale of IPO shares purchased in an offering within 30 days following the offering date, as defined in Rule 472.120.

(6) ''Penalty bid,'' as defined in Rule 100 of Regulation M, ''means an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.''

B. NASD's Proposed Rule Text

2712. IPO Allocations and Distributions

(a) Quid Pro Quo Allocations

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

(b) Spinning

No member or person associated with a member may allocate IPO shares to an executive officer or director of a company, or to a person materially supported by such executive officer or director:

(1) if the member has received compensation from the company for investment banking services in the past 12 months;

(2) if the member expects to receive or intends to seek investment banking business from the company in the next 6 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.

For purposes of paragraph (b)(2), a member that allocates IPO shares to an executive officer or director of a company, or a person materially supported by such officer or director, from which it receives investment banking business in the next 6 months will be presumed to have made the allocation with the expectation or intent to receive such business. A member, however, may rebut this presumption by demonstrating that the allocation of IPO shares was not made with the expectation or intent to receive investment banking business.

(c) Policies Concerning Flipping

(1) No member or person associated with a member may directly or indirectly recoup, or attempt to recoup, any portion of a commission or credit paid or 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 entire syndicate.

(2) In addition to any obligation to maintain records relating to penalty bids under SEC Rule 17a–2(c)(1), a member shall promptly record and maintain information regarding any penalties or disincentives assessed on its associated persons in connection with a penalty bid.

(d) Definitions

For purposes of this Rule, the following terms shall have the meanings stated below.

(1) ''Flipped'' means the initial sale of IPO shares purchased in an offering within 30 days following the offering date of such offering.

(2) ''Penalty bid'' means an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.

(3) ''Material support'' means directly or indirectly providing more than 25% of a person's income in the prior calendar year. Persons living in the same household are deemed to be providing each other with material support.

(e) IPO Pricing and Trading Practices

In an equity IPO:

(1) Reports of Indications of Interest and Final Allocations. The book-running lead manager must provide to

the issuer's pricing committee (or, if the issuer has no pricing committee, its board of directors):

(A) a regular report of indications of interest, including the names of interested institutional investors and the number of shares indicated by each, as reflected in the book-running lead manager's book of potential institutional orders, and a report of aggregate demand from retail investors;

(B) after the settlement date of the IPO, a report of the final allocation of shares to institutional investors as reflected in the books and records of the book-running lead manager including the names of purchasers and the number of shares purchased by each, and aggregate sales to retail investors;

(2) Lock-Up Agreements. Any lock-up agreement or other restriction on the transfer of the issuer's shares by officers and directors of the issuer shall provide that:

(A) Any lock-up agreement or other restriction on the transfer of the issuer's shares by officers and directors of the issuer shall provide that such restrictions will apply to their issuer-directed shares; and

(B) At least two business days before the release or waiver of any lock-up or other restriction on the transfer of the issuer's shares, the book-running lead manager will notify the issuer of the impending release or waiver and announce the impending release or waiver through a major news service;

(3) Agreement Among Underwriters. The agreement between the book-running lead manager and other syndicate members must require that any shares returned by a purchaser to a syndicate member after secondary market trading commences be used to (a) offset the existing syndicate short position or (b) if no syndicate short position exists, the member must offer returned shares at the public offering price to unfilled customers' orders pursuant to a random allocation methodology.

(4) Market Orders. No member may accept a market order for the purchase of IPO shares during the first day that IPO shares commence trading on the secondary market.

II. Self-Regulatory Organizations' Statements of the Purpose of, and Statutory Basis for, the Proposed Rule Changes

In their filings with the Commission, the NYSE and NASD included statements concerning the purpose of, and statutory basis for, the proposed rule changes.[3] The text of these statements may be examined at the places specified in Item IV below. The NYSE and NASD have prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organizations' Statements of the Purpose of, and Statutory Basis for, the Proposed Rule Changes

1. NYSE's Purpose

Proposed NYSE Rule 470 (IPO Allocations and Distributions) would govern the allocation and distribution of IPOs by members and member organizations. The Rule prohibits certain inappropriate conduct by members and member organizations in allocating and distributing IPOs and will provide the investing public with a greater degree of confidence in the IPO process and the capital markets as a whole.

Background

According to the NYSE, a series of regulatory investigations identified certain types of questionable conduct by securities underwriters and others involved in the IPO process. Examples of such conduct noted by the NYSE included, among others: (1) ''spinning,'' whereby underwriters allocated hot IPO shares to executives of prospective investment banking clients in return for future investment banking business; (2) unlawful ''quid pro quo'' arrangements, whereby underwriters allocated 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 organization; (3) the inequitable imposition of penalty bids (reclaiming of selling concessions) upon retail brokers, but not brokers servicing institutional clients, whose clients immediately sold (flipped) IPO shares in the aftermarket; and (4) allocating IPO shares based on agreements to pay excessive commissions for unrelated securities transactions.

In August 2002, the NYSE and NASD, at the request of the SEC, established an IPO Advisory Committee (the ''Committee'') to address the practices noted above, review the IPO process as a whole, and make recommendations to address these issues and improve the process in general. The work of the IPO Advisory Committee resulted in the issuance of a report in May 2003.[4]

Recognizing the importance of IPOs to the vitality of our capital markets, the Committee solicited and/or received input from all constituencies involved in this process, including investment bankers, venture capitalists, individual and institutional investors, and listed companies. The Committee also received input from various trade organizations (*i.e.*, Association of Publicly Traded Companies), and from representatives from academia as well.

The Committee proposed 20 recommendations that address four major subject areas: (1) The IPO process must promote transparency in pricing and avoid aftermarket distortions; (2) Abusive allocation practices must be eliminated; (3) Regulators must improve the flow of, and access to, information regarding IPOs; and (4) Regulators must encourage underwriters to maintain the highest possible standards, establish issuer education programs regarding the IPO process, and promote investor education about the advantages and risks of IPO investing.[5]

In terms of rulemaking, the recommendations cover three areas: (1) Recommendations requiring SEC Rulemaking; (2) Recommendations requiring SRO rulemaking; and (3) Recommendations that may require changes to marketplace listing standards.

The Exchange is proposing NYSE Rule 470 to address the following recommendations in the IPO Report:

(a) *Recommendations 2 and 14/Proposed NYSE Rule 470(D)(1)*—Require the managing underwriter to disclose indications of interest and final allocations to an issuer's pricing committee or, if the issuer has no pricing committee, to its board of directors.

(b) *Recommendation 4/Proposed NYSE Rule 470(E)*—Prohibit the acceptance of market orders to purchase IPO shares in the aftermarket for one trading day following an IPO.

(c) *Recommendation 5/Proposed NYSE Rule 470(C)*—Prohibit the inequitable imposition of ''flipping'' penalties (penalty bids) on associated persons whose customers flip IPO shares.

(d) *Recommendation 6/Proposed NYSE Rule 470(D)(3)*—Establish

[3] The Commission notes that the Exchange intends for the text contained in Amendment No. 1 to be included in its statement of the purpose for the proposed rule change. Telephone conversation between William Jannace, attorney, NYSE, Douglas Preston, attorney, NYSE, Joan Collopy, special counsel, Division of Market Regulation, Commission, and Bradley Owens, attorney, Division of Market Regulation, Commission (December 10, 2004).

[4] *NYSE/NASD IPO Advisory Committee, Report and Recommendations,* (May 2003), which is available at *http://www.nyse.com/pdfs/iporeport.pdf* (''IPO Report'').

[5] *See* IPO Report, page 3.

procedures designed to prevent reneged IPO allocations from being used to benefit favored clients of the underwriter.

(e) *Recommendation 9/Proposed NYSE Rule 470(B)*—Prohibit the allocation of IPO shares (1) to executive officers and directors (and their household members) of companies that have an investment banking relationship with the underwriter, or (2) as a ''quid pro quo'' for investment banking business.

(f) *Recommendation 11/Proposed NYSE Rule 470(A)*—Prohibit the allocation of IPO shares as consideration or inducement for the payment of excessive compensation for other services provided by the underwriter.

(g) *Recommendation 17/Proposed NYSE Rule 470(D)(2)(a)*—Require that lock-up agreements apply to shares owned by the issuer's officers and directors as well as to ''issuer-directed'' shares.

(h) *Recommendation 17/Proposed NYSE Rule 470(D)(2)(b)*—Impose new notification requirements when underwriters waive lock-ups.

According to the NYSE, some of the Committee's other recommendations will not require rulemaking. In this regard, the Committee recommended additional requirements for enhanced periodic internal review by underwriters of their IPO supervisory procedures and a heightened focus on the IPO process by the SROs. The Exchange will address these recommendations through its regulatory examinations of members and member organizations.

Although the Exchange is proposing new NYSE Rule 470 regarding IPO allocations and distributions, the federal securities laws and the Exchange rules already prohibit certain IPO allocation and distribution abuses. According to the Exchange, NYSE Rule 470 is proposed to address certain of the issues raised in the IPO Report and is intended to complement existing federal securities laws and Exchange Rules, which will continue to apply after the proposed rule change is effective.

Discussion of Proposed Rule Provisions

According to the NYSE, the IPO Report noted that certain allocation practices raise an appearance of impropriety, and that rules should be adopted to address this issue. Accordingly, the Exchange is proposing a rule to make unlawful the practice of ''spinning'' and other ''quid pro quos'' by members and member organizations as inducement for the receipt of investment banking business.

Proposed NYSE Rule 470(A)—Quid Pro Quo Allocations

According to the NYSE, proposed NYSE Rule 470(A) 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. The NYSE believes that while the federal securities laws and Exchange rules generally prohibit abusive IPO allocation and distribution arrangements, such as where underwriters allocate IPO shares based on a potential investor's agreement to pay excessive commissions on trades of unrelated securities or based on the recipient's agreement to ''kick back'' to the underwriter, either through excess commissions or otherwise, a portion of flipping profits, the proposed rule would specifically prohibit such conduct. According to the NYSE, the proposed prohibition, however, 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 of the member or member organization, even when a customer has retained the member or member organization for services.

Proposed NYSE Rule 470(B)—Spinning

According to the NYSE, as originally proposed, NYSE Rule 470(B) would prohibit the awarding of IPO shares to executive officers and directors and their household members of issuers that have, or will have, an investment banking relationship with the member or member organization on the condition that such officers and directors, on behalf of the issuer, direct future investment banking business to the member or member organization (commonly referred to as ''spinning'').

In Amendment No. 1, the Exchange substituted the term ''company'' for ''issuer,'' as many of the practices addressed in the proposed rule may occur prior to a company becoming an issuer. Further, the prohibitions against such allocations would also extend to affiliates of the company.

In Amendment No. 1, the Exchange amended its original prohibition precluding allocations to executive officers or directors of a company to include persons ''materially supported'' by such officers or directors if the member or member organization expects to receive or intends to seek investment banking business from the company in the next six months. Previously, the proposed rule change applied to household members of such persons and only looked forward three months.

In addition, Amendment No. 1 adds the 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, then the IPO allocations were made with the expectation or intent to receive such business. The proposed rule states that a member or member organization may rebut this presumption. According to the Exchange, such evidence could include procedures that ensure investment banking personnel involved in allocations do not have any information about the beneficial owners of retail accounts that received allocations.

In Amendment No. 1, the Exchange is proposing to define ''material support'' to mean ''* * * directly or indirectly, providing more than 25% of a person's income in the prior calendar year. Persons living in the same household are deemed to be providing each other with material support.''

Proposed NYSE Rule 470(C)—Policies Concerning Flipping

According to the NYSE, proposed NYSE Rule 470(C) would prohibit the inequitable imposition of a flipping penalty (penalty bids) on associated persons whose customers flipped IPO shares unless such penalty is imposed on the entire underwriting syndicate. In Amendment No. 1, the Exchange deleted the term ''underwriting'' from the term ''underwriting syndicate'' to ensure that penalty bids for flipping be assessed on the entire syndicate, not just the underwriting syndicate (*e.g.*, the selling group).

Rule 104 of Regulation M under the Exchange Act,[6] permits underwriters to impose penalty bids (as defined in Rule 100 of Regulation M)[7] on syndicate members. ''Penalty bid,'' as defined in Rule 100 of Regulation M, means ''an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities sold by the syndicate member are purchased in syndicate transactions.'' The purpose of imposing penalty bids is to promote a stable aftermarket, whereby purchasers of the offering remain long-term shareholders of the securities and not merely speculators seeking to lock-in instant profits, as was prevalent during the

[6] 17 CFR 242.104.

[7] 17 CFR 242.100.

recent stock market bubble of the late 1990s.

According to the NYSE, regulatory investigation revealed instances where, while penalty bids where not imposed upon syndicate members, such members themselves selectively imposed such penalties upon certain of their brokers whose customers (generally retail) flipped IPO shares in the immediate aftermarket. Similar penalties were not imposed upon brokers whose institutional type investors engaged in the same trading patterns. Selective imposition of penalty bids upon retail brokers resulted in these brokers discouraging their retail customers from selling immediately in the aftermarket, while implicitly permitting institutional-type investors to sell during this same time period.

According to the NYSE, proposed NYSE Rule 470(C)(1) addresses this inequity by prohibiting the imposition of penalty bids upon an associated person of a member or member organization, unless the penalty has been imposed on the entire syndicate. As proposed, NYSE Rule 470(C)(1) would not affect the applicability of Rule 104 of Regulation M as it pertains to penalty bids.

In addition, as proposed, members and member organizations would be required to maintain records of penalty bids in accordance with Rule 17a–2(C)(1)[8] under the Exchange Act. Rule 17a-2(C)(1) imposes recordkeeping requirements on managers or syndicates in connection with syndicate covering transactions and the imposition of penalty bids. In Amendment No. 1, the Exchange is proposing that all members and member organizations, not solely managers as 17(a)–2(c)(1) prescribes, be subject to recordkeeping requirements for any penalties or disincentives assessed on their associated persons in connection with a penalty bid.

Proposed NYSE Rule 470(D)—IPO Pricing and Trading Practices

Disclosure of Indications of Interest and Final Allocations

As originally proposed, NYSE Rule 470(D)(1) requires book-running lead managers to disclose in a regular report indications of interest and final allocations 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 this process. In Amendment No. 1, the Exchange amended the proposed rule to substitute ''book-running lead manager'' for ''managing underwriter,'' to reflect market practice whereby the book-running lead manager maintains this information.

The Exchange believes that disclosure of each retail customer's indications of interest (and subsequent allocations) would be of limited benefit to issuers and their pricing committees. According to the NYSE, the underlying purpose of this proposal is to ensure that the issuer or its pricing committee has a clear picture of the demand for its securities. Thus, the NYSE believes that information about each retail investor would generally not be helpful. Accordingly, the Exchange is amending its proposed rule to require that the book-running lead manager provide a ''regular report'' of indications of interest for its institutional book, including names of interested institutional investors and the number of shares indicated by each, and to reflect retail demand in aggregate terms only.

The Exchange believes that a regular report of institutional investors' indications of interest should be made as often as appropriate, including when a material change occurs, or in connection with certain meetings with the issuer or its pricing committee, and as frequently as requested by the issuer or its pricing committee. The Exchange is aware that book-running lead managers, and to a certain extent syndicate managers, have regular meetings to discuss the book-building process, including indications of interest from institutional investors. Also, the book-running lead manager usually has frequent and daily discussions with issuers about the level of indications of interest. The proposed rule change would conform to these practices.

According to the NYSE, the pricing of an IPO is determined, in part, by investor demand. Investor demand is measured by preliminary indications of interest underwriters receive up to the time an offering is declared effective by the Commission. In requiring disclosure of such information, the Exchange will promote greater transparency in IPO pricing, a stated goal of the IPO Report.

In Amendment No. 1, the Exchange amended proposed Rule 470 (D)(1)(b) to require the book-running lead manager to provide the report on final allocations within a reasonable time after ''settlement date'' rather than after ''closing date.'' The settlement date and closing date may, at times, be the same date; but the term ''settlement date'' is more precisely understood as the date on which the issuer transfers its shares in return for offering proceeds from the syndicate.

Limitations on ''Friends and Family'' Programs

The IPO Report recommends promoting greater transparency with regard to ''issuer-directed'' allocations such as ''friends and family'' programs. ''Friends and family'' programs are ''issuer-directed allocations of a portion of an offering used to permit company employees to invest in their employer at the IPO price, or to permit strategic business partners to have a small investment in the issuer.''[9] According to the NYSE, lock-ups are essential, in the early stages of the life of a company going public, for maintaining a stable aftermarket following an IPO. Subjecting a greater number of shares to such agreements will help foster this stable aftermarket by preventing shares, not ordinarily subject to lock-ups, from being sold in the immediate aftermarket.

Requirements Concerning Lock-up Exemptions

As proposed, NYSE Rule 470(D)(2)(a) would require that lock-up agreements also apply to officers' and directors' ''issuer-directed'' shares, in addition to their other shares that are subject to such agreements. Proposed NYSE Rule 470(D)(2)(b) would require prior notification when lock-ups expire or are waived. Further, proposed NYSE Rule 470(D)(2)(b) would require 2-day prior notification to the issuer by a book-running lead manager through a major news service.[10] The NYSE believes this notification requirement will benefit an issuer's shareholders and the marketplace in that it will ensure that they are aware of this prior information to and not after the sale by directors and officers of the issuer.

In Amendment No. 1, the Exchange amended proposed NYSE Rule 470 (D)(2) to clarify that the required public announcement by the book-running lead manager must be made at least two days before the release or waiver of any lock-up requirement through a major news service. According to the NYSE, the IPO Advisory Committee concluded that investors reasonably expect that the issuer's directors, officers and large pre-IPO shareholders who agree to ''lock-up'' their shares will be bound by those agreements for the stated period. As a result, the proposed rule provides that the book-running lead manager should announce any release or waiver of a lock-up agreement at least two business

[8] 17 CFR 240.17a–2(c)(1).

[9] *See* IPO Report, page 13.

[10] Recommendation 17 of the IPO Report also requires that issuers file a Form 8–K, prior to the time on insider makes sales pursuant to the expiration or waiver of the lock-up. According to the NYSE, this would require SEC rulemaking.

days before through a major news service. The Exchange believes it is important to make clear that this notification requirement applies to a release or waiver of lock-ups by the issuer and any selling shareholder.

The Exchange does not believe that placing such notice on the managing underwriter(s) Web site will provide for sufficient public dissemination of such information. Often, a member or member organization Websites contain large amounts of information and may provide challenges to locating specific information. As such, the Exchange believes that notice of the release or waiver of any lock-up or other restriction should be disseminated through a broad non-exclusionary distribution medium to the public, such as through major news services. Accordingly, the Exchange amended its Filing to limit dissemination to this prescribed manner and not permit dissemination through a Web site, as originally proposed in their Filing.

According to the NYSE, such a notice must be released by the fastest available means. The fastest available means may vary in individual cases and according to the time of day. To ensure adequate coverage, releases should be marked ''For Immediate Release'' and should be given to, for example, Dow Jones & Company, Inc., Reuters Economic Services and Bloomberg Business News. The book-running lead manager is also encouraged to promptly distribute such notices to, for example, the Associated Press and United Press International, as well as to newspapers in New York City and in cities where the issuer is headquartered or has other major facilities. According to the NYSE, every notice should include the name and telephone number of an official at the book-running lead manager who will be available if a newspaper or news wire service desires to confirm or clarify the notice.[11]

The NYSE believes proposed NYSE Rule 470 (D)(2)(b) will help facilitate members' and member organizations' compliance with recently enacted amendments to NYSE Rule 472,[12] which prohibits managers and co-managers of a securities offering from publishing research or offering opinions during a public appearance on an issuers' securities within 15 days prior to or after the expiration or waiver of a lock-up agreement. According to the NYSE, requiring prior public notification should prevent the inadvertent issuance of reports, and/or the making of public appearances through ignorance of the expiration, or waiver of such agreements.

Returned Shares

The IPO Report recommended the establishment of clear parameters for underwriters' sales of returned shares after secondary market trading has commenced. It noted 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 locked-in profit.[13]

In response to this practice, proposed NYSE Rule 470(D)(3) 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 covered, offer those shares to customers' unfilled orders at the public offering price pursuant to a random allocation methodology.

While the proposed rule change does not specify a particular methodology, the Exchange expects that members and member organizations will develop systems to randomly allocate in an objective non-discriminatory manner. According to the Exchange, member and member organizations may use the allocation of option exercise notices as an example when designing such a system. According to the Exchange, in requiring the use of a random allocation methodology, members and member organizations will be limited in their ability to benefit certain preferred customers by selecting a particular customer or group of customers to receive a guaranteed profit.

Limitation on Market Orders for One Day Following an IPO

Proposed NYSE Rule 470(E) would prohibit the acceptance of market orders to purchase IPO shares in the aftermarket for one trading day following an IPO. The IPO Report noted that IPOs are ''inherently more volatile than stocks with a public trading history,'' and that the placement of market orders by individuals in the immediate aftermarket may not ''reflect their true investment decisions nor their reasonable expectations.'' [14] Therefore, the Committee reasoned that prohibiting the acceptance of market orders immediately following an IPO would allow the market to develop more trading information and thus make the placement of such orders more appropriate for investors. In addition, institutional investors generally rely on limit orders for IPOs in the aftermarket. In this regard, the Exchange does 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.

The NASD has filed proposed amendments with the SEC to address some of the recommendations noted above and has sought membership comment on additional proposed amendments. The staffs of both the Exchange and NASD are coordinating their efforts in an attempt to promulgate consistent rules.

The Exchange believes that enactment of the proposed Rule will complement and enhance recent Exchange initiatives including the Research Analysts' Conflicts Rules,[15] the Research Analysts Global Settlement,[16] and new Corporate Governance Listing Standards.[17]

2. NYSE's Statutory Basis

The Exchange believes that the basis for the proposed rule change is the requirement under Section 6(b)(5) [18] of the Exchange Act that the rules of the Exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general to protect investors and the public interest.

3. NASD's Purpose

NASD is proposing new NASD Rule 2712, which will better ensure that members avoid unacceptable conduct when they engage in the allocation and distribution of IPOs. The proposed rule change also is intended to sustain public confidence in the IPO process, which is critical to the continued success of the capital markets.

In August 2002, the SEC requested that NASD and the NYSE convene a high-level group of business and academic leaders to review the IPO

[11] *See also,* NYSE Listed Company Manual, Section 202.06 (Procedure for Public Release of Information).

[12] *See* NYSE Rule 472(f)(4).

[13] *See* IPO Report, pages 6 and 7.

[14] *See* IPO Report, page 6.

[15] *See* Securities Exchange Act Release No. 48252 (July 29, 2003), 68 FR 45875 (August 4, 2003), (SR–NYSE 2002–49).

[16] *See* Litigation Release No. 18438 (October 31, 2003).

[17] *See* Securities Exchange Act Release No. 48745 (November 4, 2003) (SR–NYSE–2002–33).

[18] 15 U.S.C. 78f(b)(5).

process, to recommend ways to address the problems evidenced during the hot market of the late 1990s and 2000, and to improve the underwriting process. In May 2003, the NYSE and NASD IPO Advisory Committee (''Committee'') issued its final report, which contains 20 recommendations.[19] In November 2003, NASD published *Notice to Members* 03–72 requesting comment on the Committee's recommendations applicable to NASD. The proposals in *Notice to Members* 03–72 supplemented proposals initially presented for comment in *Notice to Members* 02–55, which were filed with the SEC on September 15, 2003 and amended on December 9, 2003. NASD received 39 comment letters [20] in response to Notice to Members 03–72, which are discussed below.

Although NASD is proposing new rules addressing IPO allocations, the federal securities laws and existing NASD rules already prohibit IPO allocation abuses. In recent years NASD has brought several disciplinary actions with respect to violations of these provisions. These laws and rules would continue to apply, and will continue to be the subject of possible NASD enforcement, after the proposed rule change becomes effective. Moreover, each provision in proposed NASD Rule 2712 would apply independently. Compliance with one provision would not provide a safe harbor with respect to the other provisions of the Rule or with respect to other federal securities law and existing NASD rules.

A. Prohibition of Abusive Allocation Arrangements

NASD Rule 2712(a) would expressly prohibit a member and its associated persons from offering or threatening to withhold an IPO allocation as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the member. This provision would prohibit this activity not only with respect to trading services, but to any service offered by the member. In addition, trading activity that serves no economic purpose other than to generate compensation for the member (*e.g.*, wash sales) would be viewed as ''excessive'' in relation to the services provided by the member, which are meaningless.

NASD does not intend that this prohibition interfere with legitimate customer relationships. For example, this provision is not intended 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.

B. Prohibition of Spinning

According to the NASD, ''spinning,'' or awarding IPO shares to the executive officers and directors of an investment banking client, divides the loyalty of the agents of the company (*i.e.*, the executive officers and directors) from the principal (*i.e.*, the company) on whose behalf they must act. The NASD believes this practice is inconsistent with just and equitable principles of trade.

As proposed in *Notice to Members* 02–55, NASD Rule 2712(b) would have expressly prohibited a member and its associated persons from allocating IPO shares to an executive officer or director of a company on the condition that the executive officer or director, on behalf of the company, direct future investment banking business to the member. The rule also would have expressly prohibited IPO allocations to an executive officer or director as consideration for directing investment banking services previously rendered by the member to the company.

The NYSE/NASD IPO Advisory Committee supported the spinning proposal in *Notice to Members* 02–55 with several modifications. First, the Advisory Committee recommended that NASD prohibit an allocation of IPO shares to immediate family members of an executive officer or director whenever an allocation to the officer or director would be prohibited. The NASD amended the rule to eliminate the definition of immediate family and instead apply the prohibition on spinning just to persons ''materially supported'' by an executive officer or director of a company. This concept of material support is the same as used in NASD Rule 2790 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings).[21] This change narrows the scope of the spinning prohibition to include only those members of the immediate family that live in the same household as the executive officer or director and is similar in scope to the provisions in NASD Rule 2711 (Research Analysts and Research Reports). The definition, however, captures persons outside of an executive officer's or director's immediate family if such executive officer or director, directly or indirectly, provides more than 25% of the person's income in prior calendar year.

Second, the Advisory Committee recommended that NASD bar IPO allocations to all executive officers and directors of a company with whom a member has an investment banking relationship. The Advisory Committee believed that the very existence of an investment banking relationship created, at the very least, an appearance of impropriety. NASD has amended the proposed rule change to incorporate this suggestion.

Consequently, proposed NASD Rule 2712(b) would prohibit the allocation of IPO shares to an executive officer or director of a company, or to persons materially supported by such an executive officer or director, if the member had received compensation from the company for investment banking services in the past 12 months. In addition, NASD has expanded the prohibition in proposed NASD Rule 2712 (b)(2) to preclude allocations to executive officers or directors of a company if the member expects to receive or intends to seek investment banking business from the company in

[19] *See* IPO Report, *supra* note 4.

[20] Letter from Alan R. Gordon dated November 25, 2003; Letter from Alan Tobey dated November 28, 2003; Letter from Allen Skaggs dated November 30, 2003; Letter from Peter W. LaVigne, American Bar Association, dated February 4, 2004; Letter from Banner Capital Markets LLC dated January 9, 2004; Letter from Bruce E. Holmes, PE, dated November 29, 2003; Letter from Harold Jones, Coughlin & Company Inc., dated January 9, 2004; Letter from Daniel M. Chernoff dated November 28, 2003; Letter from Don Brewer dated November 28, 2003; Letter from Edward J. Fedeli dated November 28, 2003; Letter from Edward M. Alterman, Fried, Frank, Harris, Shriver & Jacobson LLP, dated January 23, 2004; Letter from HGM dated November 28, 2003; Letter from J D Harris dated November 28, 2003; Letter from *Jandonbar@aol.com* dated November 30, 2003; Letter from Jeffrey E. Teich, Ph.D, dated November 25, 2003; Letter from *Lertel7635@aol.com* dated November 29, 2003; Letter from Malcolm R. Powell, M.D, dated November 28, 2003; Letter from Mandar Mirashi dated November 29, 2003; Letter from Mark H. Rapier dated November 30, 2003; Letter from Lawrence M. Ausubel, Market Design Inc., dated January 23, 2004; Letter from *Mohme@aol.com* dated November 29, 2003; Letter from Lester Morse, Esq., Morse & Morse, PLLC dated January 15, 2004; Letter from Jed Bandes, Mutual Trust Co. of America Securities, dated November 28, 2003; Letter from Ralph A. Lambiase, NASAA, dated January 26, 2004; Letter from Mark G. Heesen, NVCA, dated January 16, 2004; Letter from Henry P. Williams, Oppenheimer & Co., Inc., dated January 9, 2004; Letter from Patricia Evans dated November 29, 2003; Letter from Paul N. Mullen dated November 28, 2003; Letter from Peggy Hutchinson dated November 29, 2003; Letter from Peter Locke dated November 28, 2003; Letter from *RAMSkMgt@yahoo.com* dated November 28, 2003; Letter from Richard O. Gregory dated November 29, 2003; Letter from Rick Street dated November 29, 2003; Letter from Scott Cook dated January 23, 2004; Letter from John Faulkner, Securities Industry Association, dated January 23, 2004; Letter from Steve Antenozzi dated November 27, 2003; Letter from Thomas Weitzner dated November 30, 2003; Letter from Dr. Ann E. Sherman, University of Notre Dame, January 23, 2004; and Letter from William R. Hambrecht, WR Hambrecht & Co., dated January 9, 2004.

[21] *See* 68 FR 62126 (October 21, 2003).

the next 6 months. Previously, the proposed rule change only looked forward 3 months. The language of these provisions is based on similar language in NASD Rule 2711, concerning disclosure of investment banking compensation in research reports.[22]

In addition, the proposed rule change adds a presumption in paragraph (b)(2), stating 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, that the IPO allocations were made with the expectation or intent to receive such business. A member may rebut this presumption. According to the NASD, evidence to rebut this presumption could include procedures and information barriers that ensure that investment banking personnel involved in allocations do not have any information about the beneficial owners of retail accounts that received allocations.

Under the proposed rule change, the accounts of executive officers and directors and their immediate family would, in effect, be restricted accounts similar to the accounts subject to the Free-Riding and Withholding Interpretation (IM–2110–1). Accordingly, NASD requests comment on whether the prohibition should be codified in NASD Rule 2790, which was recently approved by the SEC[23] and is slated to replace the Free-Riding and Withholding Interpretation.

In *Notice to Members* 02–55, NASD proposed to amend NASD Rule 2710, the Corporate Financing Rule, to require that members file information regarding the allocation of IPO shares to executive officers and directors of a company that hires a member to be the book-running managing underwriter of the company's IPO. This requirement was designed to assist the NASD in monitoring the possibility that allocations were made in return for investment banking business. Under the amended proposal, all allocations to executive officers or directors of investment banking clients or potential clients would be prohibited. According to the NASD, the proposed reporting requirement under NASD Rule 2710 appears to be unnecessary and has been deleted from the proposal.

C. Restrictions on Penalty Bids

NASD Rule 2712(c) would prohibit members from penalizing associated persons whose customers have ''flipped'' IPO shares that they have purchased through the member, unless a penalty bid, as defined in Rule 100 of SEC Regulation M has been imposed. Rule 100 defines a penalty bid as ''an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.''

Rule 104 of Regulation M and Nasdaq Stock Market Rule 4624 provide notice and record keeping requirements for penalty bids. Penalty bids may be assessed in the aftermarket of an offering that is under downward price pressure from an imbalance of sell orders relative to purchase orders. NASD does not oppose this use of penalty bids. However, according to the NASD, some members have penalized their registered representatives in connection with flipping by retail customers, even when the managing underwriter has not assessed a penalty bid on the syndicate members. For example, members have penalized their registered representatives by recouping the commission or credits previously granted for the sale of IPO shares.

According to the NASD, the practical consequence of this practice is that registered representatives are penalized, and their retail customers may be pressured to retain their long position in the IPO shares, while representatives for institutional customers generally are not penalized at all for flipping activity by their customers. According to the NASD, the inequity of this selective penalization is most difficult to justify in light of the fact that most IPO shares are typically allocated to institutional customers. The NASD believes that the proposed rule would effectively prohibit this selective practice by permitting members to assess internal penalties on their registered representatives only when the managing underwriter has imposed a penalty bid on the syndicate members. The provision would not place any limit on syndicate penalty bids, however. This proposal was supported by the IPO Advisory Committee.

D. IPO Pricing and Trading Practices

a. Disclosure of Indications of Interest and Final Allocations

The IPO Advisory Committee recommended that issuers establish a pricing committee to evaluate the proposed offering price, and that underwriters be required to disclose to the issuer's pricing committee all indications of interest received before the issuer finalizes the IPO price. The Committee also recommended that underwriters be required to disclose to the issuer the final allocations after the offering is priced. The Committee concluded that greater participation by issuers in pricing and allocation decisions would better ensure that those decisions are consistent with the fiduciary duty of directors and management, and would provide management with more information to evaluate the underwriter's performance. A requirement that issuers establish a pricing committee would necessitate a listing standard by The Nasdaq Stock Market and the NYSE.

In *Notice to Members* 03–72, NASD solicited comment on a proposed rule change that would require that the underwriting agreement between the book-running lead manager and the issuer require that the book-running lead manager provide the issuer's pricing committee (or its board of directors if the issuer does not have a pricing committee) with: (1) a regular report of indications of interest, including the names of interested investors and the number of shares indicated by each, and (2) after the closing date of the IPO, a report of the final allocation of shares available to the manager, including the names of purchasers and the number of shares purchased by each.

According to the NASD, commenters generally supported these requirements but suggested the following changes.

1. Institutional vs. Retail Disclosure

Some commenters suggested that the report of indications of interest and final allocations should relate only to the ''institutional pot.'' Several commenters suggested that it is not practical for the book-running lead manager to provide the names of all individual investors who have expressed an indication of interest because the book-running lead manager does not collect the names of individual retail investors. Commenters also stated that brokerage firms consider the names of their individual investor clients to be proprietary information and confidentiality concerns may limit the ability of brokerage firms to disclose the names of individual investors to the book-running lead manager. Commenters also stated that retail indications of interest are usually submitted to a firm's syndicate desk as branch aggregates, not on an individual-by-individual basis. Finally, commenters suggested that information regarding the names of individual investors is likely to be of limited use to an issuer because, in an IPO, there could be thousands of individual investors.

NASD agrees that disclosure of each retail customer's indications of interest

[22] NASD rule 2711(h)(2)(A).

[23] *See* 68 FR 62126 (October 21, 2003).

(and subsequent allocations) would be of limited benefit to issuers and their pricing committees. The underlying purpose of this proposal is to ensure that the issuer or its pricing committees has a clear picture of the demand for its securities. Thus, the NASD believes that information about each individual retail investor would generally not be helpful. Accordingly, the NASD has revised the proposed rule change to require that the book-running lead manager disclose its institutional book of interest and to reflect retail demand in aggregate terms only.

2. Timing of Disclosure

One commenter suggested that rather than a ''regular report'' of indications of interest, the rule should require that the book-running lead manager provide information in a timely manner prior to pricing, or as frequently as requested by the issuer's pricing committee. Another commenter suggested that the book-running lead manager should be required to provide a single report of the major institutional indications of interest shortly before or at the time of pricing the offering.

The proposed rule would require a regular report of indications of interest, which report should be made as often as appropriate, including such as when a material change occurs, or in connection with certain meetings with the issuer or its pricing committee, and always as frequently as requested by an issuer or its pricing committee. Indeed, the NASD's understanding of the bookbuilding process is that most underwriters have frequent and even daily discussions with issuers about the level of indications of interest. The proposed rule change thus would codify this practice.

In response to one commenter, however, NASD has amended the proposed rule change to require the book-running lead manager to provide the report on final allocations within a reasonable time after ''settlement date'' rather than after ''closing date.'' The settlement date and closing date can be the same date, but the term ''settlement date'' may be more precisely understood as the date on which the issuer transfers its shares in return for offering proceeds from the syndicate.

3. Additional Disclosure

One commenter suggested that issuers would benefit from receiving information regarding relationships that underwriters have with purchasers. This commenter suggested that issuers would benefit from receiving additional information regarding the intended holding periods of purchasers, since issuers generally favor allocations to long-term holders over ''flippers.''

According to the NASD, this information generally may be useful or relevant to issuers. As the specificity of information about past account activity increases, however, financial privacy concerns also increase. Brokerage customers may reasonably expect that their broker will keep particular information about trades they have made in their accounts confidential. In addition, SEC Regulation M prohibits underwriters during the bookbuilding process from attempting to induce purchases in the aftermarket. This limits some of the information the underwriters are permitted to obtain and provide to the issuer regarding whether any particular account will be buying or selling the securities in the aftermarket. Accordingly, NASD has not included this requirement as part of the proposed rule change.

One commenter suggested that disclosure of different levels of interest at different prices should be required and that NASD should require a graphical display of this information. NASD believes that members should be able to design their forms of communication on indications of interest and final allocations as appropriate to particular offerings and issuers. Members, of course, may compete for investment banking business by offering certain disclosures and forms of disclosure, and likewise, issuers may condition an engagement with an investment bank on certain disclosures and forms of disclosure.

4. Underwriting Agreements

Several commenters stated that the obligation to provide indications of interest to the issuer should not be included in the underwriting agreement because the underwriting agreement is not signed until after pricing of the offering. These commenters suggested that NASD impose the obligation on the book-running lead manager directly. NASD agrees and has amended the proposed rule change accordingly.

b. Limitation on Market Orders for One Day Following an IPO

The IPO Advisory Committee recommended a prohibition on market orders for one trading day following an IPO. The Committee concluded that in light of the volatility of IPO issues, investors who place market orders immediately following an IPO may inadvertently purchase at prices that neither reflect their true investment decisions nor their reasonable expectations. Commenters, such as the SIA, generally opposed this proposal. Some commenters suggested that educating retail investors about the appropriate use of limit orders was the appropriate remedy. Commenters also stated that restricting investors only to 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.

NASD is not persuaded by the commenters that banning market orders for IPOs on the first trading day will have significant effects on liquidity or price discovery. Institutional investors rely almost exclusively on limit orders in the IPO aftermarket. NASD requests further comment on why the use of limit orders by retail investors will not allow markets to develop sufficient liquidity or become an effective tool for price discovery.

c. Returned Shares

The IPO Advisory Committee offered a recommendation concerning IPO shares that are returned to the underwriter after completion of distribution. The Committee noted that currently if an IPO's shares trade at an immediate aftermarket premium, underwriters can allocate returned shares to favored customers at the IPO price, providing what might be a guaranteed profit to those customers. To address this concern, NASD solicited comment on a proposed rule change that would require underwriters first to allot returned shares to the existing syndicate short position. If there is no short position, or if the short position already has been covered by the time the shares are returned, the proposal would have permitted members to sell the remaining returned shares on the open market and return net profits to the issuer. The proposed rule change provided that if the market price does not rise above the offering price, then the underwriter would be permitted to sell the shares at a loss for its account or retain the shares by placing them in its investment account.

Commenters and SEC staff raised concerns that, among other things, the proposal's disposition of returned shares in the event that there is no existing short position may conflict with Regulation M. In response to these concerns, NASD has amended the proposed rule change to require that if no existing short position exists at the time that returned shares are received by a member firm, then the members must offer those shares to unfilled customers' orders *at the public offering price* pursuant to a random allocation methodology. While the proposed rule change does not specify a particular methodology, NASD expects that

members will develop systems similar to those used to allocate options exercise notices.[24] In general, these systems will require sequencing of all relevant accounts, assigning a sequence number to each account, and then generating a random number to identify where in the sequence to begin offering returned shares. According to the NASD, in requiring the use of a random allocation methodology, NASD prevents members from being in a position to benefit by selecting a particular customer or group of customers to receive a guaranteed profit.

d. Limitations on ''Friends and Family'' Programs

The IPO Advisory Committee recommended requiring that any lock-up that applies to shares owned by officers and directors include the shares purchased by those individuals in the ''friends and family'' program. In *Notice to Members* 03–72, NASD solicited comment on a proposed rule change to require that any lock-up or restriction on the transfer of the issuer's shares also apply to issuer-directed shares held by officers and directors of the issuer. According to the NASD, commenters generally supported this proposal. One commenter believed that this proposal should be effected by a listing requirement rather than an NASD rule. NASD disagrees. Insofar as the lock-up agreement is a contractual arrangement between the underwriter and the issuer, the NASD believes that imposing the requirement on the underwriter is appropriate.

e. Requirements Concerning Lock-Up Exemptions

The IPO Advisory Committee concluded that investors reasonably expect that the issuer's directors, officers, and large pre-IPO shareholders who agree to ''lock up'' their shares will be bound by those agreements for the stated period. The Committee recommended that the lead underwriter announce any lock-up exemption through a major news service. NASD's proposed rule change would require that the underwriting agreement provide that at least two business days before the release or waiver of any lock-up or other restriction on the transfer of the issuer's shares, the book-running lead manager will notify the issuer of the impending release or waiver and announce the impending release or waiver through a national news service.

Several commenters expressed concern that requiring the book-running lead manager to announce an impending release or waiver of a lock-up restriction on officers and directors would result in a large amount of meaningless information regarding sales of immaterial amounts of securities. NASD disagrees. According to the NASD, lock-up restrictions generally align the investment interest of the insiders subject to the lock-up with investors in the offering during the period of the lock-up. Thus, investors should find notifications of a lock-up release or waiver to be important and relevant information.

Another commenter questioned whether this notification requirement was intended to apply to the release of the issuer, selling shareholder, or both. According to the NASD, the proposed rule change will apply to a release or waiver of lock-ups by the issuer and any selling shareholder. While in many cases the release of an issuer will be followed by the filing of a registration statement before securities may be sold, that is not always the case (*e.g.*, Rule 144A offerings). Accordingly, NASD has not proposed to exempt waiver of issuer lock-ups from the proposed rule change.

One commenter also suggested that the notice requirement should be subject to some materiality or *de minimis* exception and should apply only if the release relates to a sale into the market. This commenter suggested that the notification requirement should not apply to a release that allows only for minor sales or transfers of stock in which the transferee agrees to lock-up restrictions identical to those applicable to the transferor, such as transfers by a shareholder to a family trust or to a charity. NASD does not support this modification. NASD believes that investors expect that lock-ups will be applied for their stated term, and that even small sales may be material information. NASD also does not believe that there should be an exemption where the transferee agrees to identical lock-up restrictions. According to the NASD, the fact that the shareholder or issuer no longer has accepted investment risk with regard to those securities is information that should be available to the market. In addition, if a transferee agrees to identical lock-up restrictions, any waiver or release of such restrictions as applied to such persons also must be preceded by a public announcement through a major news service.

A commenter suggested that the timing of the announcement should be based upon when a sale into the market may first take place, not when the release is to take place. Another commenter stated that two days' prior notice might not be sufficient. NASD believes that the timing of the announcement should be triggered by the release date, not the eventual sale date, and that two days seems to be an acceptable period.[25] In addition, if the waiver does not permit the immediate sale of securities into the market, then additional disclosure should be provided indicating when such sales may be permitted.

Finally, one commenter believed that disclosure by the issuer in Form 8–K would be sufficient. NASD disagrees. Form 8–K notification occurs after a sale has been made. NASD agrees with the IPO Advisory Committee that investors expect that lock-ups will be adhered to, and that they should be provided *advance* notice of any release or waiver.

f. Rulemaking Concerning the Pricing of Unseasoned Issuers

As discussed in *Notice to Members* 03–72, many IPO issuers in the late 1990s and 2000 had little or no revenues and subsequently experienced a dramatic run-up and decline in their stock price. Some critics have taken the position that the run-up demonstrates that these IPOs were underpriced; others have countered that the subsequent significant drop in the price of these securities, at times well below the IPO price, demonstrates that the offerings were actually overpriced. NASD solicited comment on three possible approaches to the regulation of IPO pricing of unseasoned issuers. Unlike the other items in *Notice to Members* 03–72, these were presented as concepts only and NASD did not propose specific rule text.

The first proposal was a requirement for an underwriter to retain an independent broker-dealer to opine that the initial IPO range at which the offering is marketed and the final offering price are reasonable and require that the independent broker-dealer's opinion is disclosed in the prospectus. Commenters generally did not support this proposal. The most common criticism was that the proposal would impose considerable cost on issuers. Commenters added that the cost of the independent opinion would be especially burdensome on smaller issuers. One commenter believed that the cost for the opinion would be affected by the assumption of liability that would result from the requirement to disclose the independent opinion in the prospectus. Another commenter argued that the responsibility for

[24] *See* Rule 2860(b)(23)(C).

[25] Tying the period of prior notice to a particular market or the average trading volume, as suggested by one commenter, would, in NASD's view, be unnecessarily complex.

recommending a public offering price should not be forced on another broker-dealer that is less involved in the offering process and likely to be less informed about the issuer and its securities. Several commenters noted that the independent broker-dealer rendering a pricing opinion would need to rely on information from the lead underwriter, or due diligence costs would be prohibitive. Finally, one commenter noted that issuers already have the ability to obtain independent pricing opinions from a second broker-dealer when they perceive a need for one.

In light of these concerns, NASD does not intend to propose a rule requiring an independent pricing opinion at this time.

The second proposal was to require the managing underwriter to use an auction or other system to collect indications of interest to help establish the final IPO price. Commenters expressed varying degrees of support for this proposal. Many commenters that appear to be individual investors supported implementation of the ''Dutch Auction'' though they offered little explanation. Other commenters opposed the adoption of any regulation that would require underwriters to use an auction approach to price setting. Several commenters stated that the market, and not regulators, should decide what pricing and allocation models are appropriate for particular IPOs. One commenter supported the development of alternatives to the bookbuilding process, but would not support the use of an auction as the only alternative. Finally, one commenter stated that the auction method is impractical for small broker-dealers because they are not familiar with this pricing mechanism.

Recent developments have focused increased attention on the use of auctions, and it appears that more issuers and investment banks are using or considering the use of auctions to assist in pricing IPOs. Given these developments, NASD finds it premature to mandate use of auction systems.

The third proposal was to require the managing underwriter to include a valuation disclosure section in the prospectus with information about how the managing underwriter and issuer arrived at the initial price range and final IPO price, such as reviewing the issuer's one-year projected earnings or P/E ratios and share price information of comparable companies. Commenters expressed varied levels of support for this proposal. Some commenters strongly supported the proposed valuation disclosure requirement. One such commenter suggested that the valuation disclosure should be accompanied by an explicit fiduciary duty making underwriters accountable for their IPO pricing decisions. This commenter expressed concern that valuation rationales and earnings estimates generally are made available only to the institutional market through the book-running underwriter's research analyst, creating an ''information monopoly'' that is inaccessible to smaller institutions and retail investors. This commenter stated that the inclusion of earnings estimates in the prospectus is a very important step in allowing all investors to receive equal access to IPO pricing information in order for the lead underwriter to develop a complete and accurate demand curve.

Several commenters noted that the initial price range and final price reflect a large number of factors, including current market conditions. One commenter noted that pricing determinations are based not only on information about the issuer, its past results, current financials, and projected earnings, but also on information about market interest, performance of the stock market in the days preceding pricing, and the willingness of the issuer to accept a lower share price to sell into a down market. Some commenters noted that much pricing information, such as the selection of comparable companies is subjective. One commenter noted that projections of future earnings are one of many data points used by investors to determine the price and quantity of shares they are interested in purchasing. This commenter noted that the market ultimately determines price, and price may be driven by ''market psychology'' and other factors that are difficult to quantify.

Several commenters also expressed reservations about the valuation disclosure proposal because it would open the issuer and underwriter to future litigation if the projections were not met. Some commenters suggested that any proposal related to disclosure of issuer projections would need to be accompanied by a safe harbor to protect issuers and underwriters from liability in future litigation. These commenters generally favored expansion of the safe harbor under Section 27A of the Securities Act of 1933 to IPOs.

Some commenters suggested that the SEC, rather than NASD, should address the matter of valuation disclosure since it involves a disclosure requirement for issuers. One commenter added that the SEC also would be able to address the attendant liability concerns affecting issuers and underwriters.

Based on the comments received, NASD believes that the SEC is the more appropriate regulator to address the inclusion of projections. The SEC regulates the contents of a prospectus and also is in a position to address issues of liability.

4. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Exchange Act, which require, among other things, that NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the new, specifically targeted provisions in the proposed rule changes will aid member compliance efforts and help to maintain investor confidence in the capital markets.

(B) Self-Regulatory Organizations' Statements on Burden on Competition

The NYSE and NASD do not believe that the proposed rule changes will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

(C) Self-Regulatory Organizations' Statements on Comments on the Proposed Rule Changes Received from Members, Participants, or Others

The NYSE has neither solicited nor received written comments on the proposed rule change. NASD requested written comments in *Notice to Members* 03–72 as discussed in Section II(A)(1) above. Additionally, NASD requested written comments in *Notice to Members* 02–55 and received four comment letters.[26] According to the NASD, all of the comment letters generally supported the proposal. The National Venture Capital Association, the Association for Investment Management and Research (''AIMR'') and the North American Securities Administrators Association, Inc. (''NASAA'') supported the amendments. NASAA noted that many of the prohibitions go to conduct that already is unlawful.

The Securities Industry Association (''SIA'') stated that ''the new and

[26] National Venture Capital Association letter to Barbara Z. Sweeney (Sept. 9, 2002); the Association for Investment Management and Research letter to Barbara Z. Sweeney (Sept. 23, 2002); North American Securities Administrators Association, Inc. letter to Barbara Z. Sweeney (Sept. 23, 2002); and Securities Industry Association letter to Barbara Z. Sweeney (Sept. 24, 2002).

specifically targeted provisions in NASD Rule 2712 would aid member compliance efforts and help to maintain investor confidence in the capital markets.'' The SIA supports proposed NASD Rule 2712(a) but has concerns about how ''excessive'' compensation might be interpreted and suggests that the term be changed to ''clearly excessive.'' NASAA also noted that ''excessive'' compensation is not defined in the Rule and believes the term creates an exception that undermines the clarity of the provision. NASD believes that use of an ''excessive'' compensation standard takes into account all of the facts and circumstances surrounding the services provided. This flexibility would allow members and NASD to take into account the risk and effort involved in the transaction, usual and customary rates charged for similar services at broker/dealers in the same kind of business, and regional norms in setting prices for financial services.

As published in *Notice to Members* 02–55, proposed NASD Rule 2712 would have prohibited certain forms of aftermarket tie-in agreements. The SIA recommended that the language in the discussion section on aftermarket tie-ins ''clarify that inquiries and discussions regarding a potential customer's interest in purchasing and holding a security not be deemed solicitations for purposes of [the aftermarket tie-in provision].'' AIMR believes the provision may be difficult to supervise or monitor and suggests that NASD ''simply require heightened supervisory scrutiny of all IPO allocations and distributions.'' NASD has determined not to pursue a proposed rule change addressing aftermarket tie-in arrangements at the present time.

According to the NASD, the SIA supported the proposal to prohibit allocations to an executive officer or director as a condition or as consideration for investment banking business, but noted that it may be difficult to determine whether an allocation has been done as a condition or as consideration for investment banking business. The proposal as amended would bar IPO allocations to all executive officers and directors of a company with whom a member has an investment banking relationship.

As proposed in the *Notice to Members* 02–55, the amendments to NASD Rule 2710 would have required that a member file a statement with NASD regarding whether an executive officer or director participated in the selection of the book-running managing underwriter. The SIA noted that underwriters cannot know with certainty who participated in their selection or the significance of their roles. In addition, the SIA believes that the proposed requirement to file information under NASD Rule 2710(b)(6)(A)(viii) with respect to the 180-day calendar period immediately following the effective date of an offering would be burdensome. As discussed above, NASD has modified the proposal to eliminate the proposed amendment to NASD Rule 2710.

The SIA recommends that the time period specified in proposed NASD Rule 2712(c)(2)(A) commence on the offering date instead of the effective date of an offering. The SIA notes that the offering date tracks the language used in the standard agreement among underwriters, which is used by member firms to track the period in which a penalty bid may be used. NASD has amended the proposal to make the change suggested by the SIA. Accordingly, the ''offering date'' for purposes of the rule is the date after pricing on which members first sell shares to the public.

As proposed in *Notice to Members* 02–55, proposed NASD Rule 2712 would have included a requirement that each member subject to the rule must adopt and implement written procedures reasonably designed to ensure that the member and its employees comply with the provisions of the rule. NASAA notes that members already are required to implement procedures to ensure compliance with NASD rules and the provision is unnecessary. NASD agrees that such procedures already are required by members and the provision has been deleted.

III. Date of Effectiveness of the Proposed Rule Changes and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the SROs consent, the Commission will:

A. By order approve such proposed rule changes, or

B. Institute proceedings to determine whether the proposed rule changes should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing proposals, including whether the proposed rule changes are consistent with the Exchange Act and whether there are any differences between the NYSE and NASD proposals that present compliance or interpretive issues.

On October 13, 2004, the Commission approved the issuance of proposed amendments to Regulation M (the anti-manipulation rule governing securities offerings).[27] Among other things, the proposed amendments would amend Rule 104 of Regulation M to prohibit the use of penalty bids and would add a new Rule 106 to expressly prohibit distribution participants, issuers, and their affiliated purchasers, directly or indirectly, from demanding, soliciting, attempting to induce, or accepting from their customers any consideration in addition to the stated offering price of the security.[28] The Commission requests additional comment on any differences between the proposed amendments to Regulation M and the SRO proposed rule changes, particularly with respect to the proposals regarding penalty bids and quid pro quo allocations,[29] which may present compliance or interpretive issues.

In addition, the Commission specifically solicits comment on proposed NASD Rule 2712(b)(2) and NYSE Rule 470(B)(2), the so-called spinning restrictions. In particular, the Commission requests comment on the SROs' proposal to employ a rebuttable presumption with respect to members allocating IPO shares to an executive officer or director of a company (or person materially supported by such officer or director) if the member expects to receive or intends to seek investment banking business from the company in the next six months. We note that both the *NYSE/NASD IPO Advisory Committee, Report and Recommendations* (May 2003) (''IPO Report'') and the *Voluntary Initiative Regarding Allocations of Securities in ''Hot'' Initial Public Offerings to Corporate Executives and Directors* (April 28, 2003) (''Voluntary Initiative'') included absolute prohibitions on allocations of IPO shares to such persons.

The SRO proposed spinning restrictions would apply to persons

[27] *See* Securities Exchange Act Release No. 50831 (December 9, 2004), 69 FR 75774 (December 17, 2004), which is available at *http://www.sec.gov/rules/proposed/33-8511.htm.*

[28] *Id.*

[29] The proposed amendments to Rule 104 of Regulation M include a proposal to prohibit penalty bids altogether, whereas proposed NASD Rule 2712(c) and NYSE Rule 470(c) are based on the continued use of penalty bids. Another potential ''inconsistency'' may be a proposed new Rule 106 of Regulation M and proposed NYSE Rule 470(A) and NASD Rule 2712(a) regarding quid pro quo allocations. *See id.*

''materially supported'' by an executive officer or director.[30] The Commission requests comment on whether the proposed spinning restrictions should also apply to ''immediate family members'' who do not live in the same household and do not receive more than 25% of their ''income'' from the officer or director, as is the case with the Voluntary Initiative and the IPO Report.[31] Should the proposed spinning restrictions also prohibit investment banking personnel from participating in the member firm's allocation of IPO shares to specific individual customers, as in the Voluntary Initiative?

In addition, the Commission specifically solicits comment on whether the proposals concerning ''returned shares'' in NYSE Rule 470(D)(3) and NASD Rule 2712(e)(3) should clarify any possible implications under Regulation M, particularly with respect to continuation of the distribution.[32]

Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically at the following e-mail address: *rule-comments@sec.gov.* All comment letters should refer to File Nos. SR–NYSE–2004–12 and SR–NASD–2003–140. These file numbers should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule changes that are filed with the Commission, and all written communications relating to the proposed rule changes between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filings will also be available for inspection and copying at the principal offices of the NYSE and NASD. All submissions should refer to File Nos. SR–NYSE–2004–12 and SR–NASD–2003–140 and should be submitted by January 18, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[33]

Margaret H. McFarland,

Deputy Secretary.

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[30] The SROs proposed to define ''material support'' to mean ''directly or indirectly providing more than 25% of a person's income in the prior calendar year. Persons living in the same household are deemed to be providing each other with material support.'' *See* NYSE Rule 470(F)(3) and NASD Rule 2712(d)(3).

[31] ''Material support'' is defined to include persons living in the same household or who receive more than 25% of their ''income'' from the officer or director. However, it may exclude close relations—such as a son or daughter—who do not live in the same household and to do not receive more than 25% of their ''income'' from the officer or director.

[32] *See* Rule 100 of Regulation M for definition of ''completion of participation in a distribution.'' 17 CFR 242.100. In order to comply with Regulation M, an underwriter or other distribution participant generally cannot commence trading in IPO securities in the secondary market unless they have completed their participation in the offering.

[33] 17 CFR 200.30–3(a)(12).

SMALL BUSINESS ADMINISTRATION

Interest Rates

The Small Business Administration publishes an interest rate called the optional ''peg'' rate (13 CFR 120.214) on a quarterly basis. This rate is a weighted average cost of money to the government for maturities similar to the average SBA direct loan. This rate may be used as a base rate for guaranteed fluctuating interest rate SBA loans. This rate will be 4.5 (4½) percent for the January-March quarter of FY 2005.

James E. Rivera,

Associate Administrator for Financial Assistance.

[FR Doc. 04–28397 Filed 12–27–04; 8:45 am]

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SOCIAL SECURITY ADMINISTRATION

Privacy Act of 1974, as Amended; New System of Records and New Routine Use Disclosures

AGENCY: Social Security Administration (SSA).

ACTION: Proposed new system of records and proposed routine uses.

SUMMARY: In accordance with the Privacy Act (5 U.S.C. 552a(e)(4) and (e)(11)), we are issuing public notice of our intent to establish a new system of records entitled *Medicare Part D and Part D Subsidy File, 60–0321,* and routine uses applicable to the system of records. We also are issuing notice that we may disclose personally identifiable information from the *Medicare Part D and Part D Subsidy File* to consumer reporting agencies in accordance with 5 U.S.C. 552a(b)(12) and 31 U.S.C. 3711(e). We invite public comment on this proposal.

DATES: We filed a report of the proposed *Medicare Part D and Part D Subsidy File* and the applicable routine uses with the Chairman of the Senate Committee on Governmental Affairs, the Chairman of the House Committee on Government Reform, and the Director, Office of Information and Regulatory Affairs, Office of Management and Budget (OMB) on December 16, 2004. The proposed *Medicare Part D and Part D Subsidy File* system of records and the proposed routine uses will become effective on January 25, 2005, unless we receive comments warranting that they not be effective.

ADDRESSES: Interested individuals may comment on this publication by writing to the Executive Director, Office of Public Disclosure, Office of the General Counsel, Social Security Administration, Room 3–A–6 Operations Building, 6401 Security Boulevard, Baltimore, Maryland 21235–6401. All comments received will be available for public inspection at the above address.

FOR FURTHER INFORMATION CONTACT: Ms. Christine W. Johnson, Strategic Issues Team, Office of Public Disclosure, Office of the General Counsel, Social Security Administration, Room 3–C–1 Operations Building, 6401 Security Boulevard, Baltimore, Maryland 21235–6401, e-mail address at *chris.w.johnson@ssa.gov,* or by telephone at (410) 965–8563.

SUPPLEMENTARY INFORMATION:

I. Background and Purpose of the Proposed New Medicare Part D and Part D Subsidy File System of Records

A. General Background

On December 8, 2003, the Medicare Prescription Drug, Improvement, and Modernization Act (MMA) of 2003, was signed into law (Public Law 108–173). The MMA creates a voluntary prescription drug benefit program under new Part D of Medicare for all individuals eligible for Medicare Part A or Part B under which a monthly premium is required to assist in the purchase of prescription drugs. The new coverage, which is effective January 1, 2006, will assist Medicare-eligible seniors, people with disabilities and persons with end-stage renal disease with their prescription drug costs. In 2006, almost all of the 43 million Medicare beneficiaries will have a chance to enroll in the subsidized drug cost program.

The MMA also created a premium subsidy program for Medicare