SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61690; File No. SR-NASD-2003-140)

March 11, 2010

Self-Regulatory Organizations; National Association of Securities Dealers, Inc. (n/k/a Financial Industry Regulatory Authority, Inc.); Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 3, Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in Initial Public Offerings ("IPOs")

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on September 15, 2003, National Association of Securities Dealers, Inc. ("NASD") (n/k/a Financial Industry Regulatory Authority, Inc. ("FINRA"))[3] filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared substantially by FINRA. NASD amended the proposed rule change on December 9, 2003 and August 4, 2004. FINRA amended the proposed rule change on February 17, 2010.[4] The Commission is publishing this notice to solicit comments on the proposed rule change, as modified by Amendment No. 3, from interested persons.

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

2 17 CFR 240.19b-4.

3 On July 26, 2007, the Commission approved a proposed rule change filed by the NASD to amend the NASD's Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc., or FINRA, in connection with the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc. See Securities Exchange Act Release No. 56146 (July 26, 2007), 72 FR 42190 (August 1, 2007) (SR-NASD-2007-053).

4 The text of the proposed rule change in Amendment No. 3 replaces and supersedes the text in the original rule filing and Amendment Nos. 1 and 2 thereto.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing Amendment No. 3 to SR-NASD-2003-140, a proposed rule change to further and more specifically prohibit certain abuses in the allocation and distribution of shares in initial public offerings ("IPOs"). The text of the proposed rule change in Amendment No. 3 replaces and supersedes the text in the original rule filing and Amendment Nos. 1 and 2 thereto.

The text of the proposed rule change is available on FINRA's Web site at http://www.finra.org, at the principal office of FINRA and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

On September 15, 2003, NASD (n/k/a FINRA) filed with the SEC SR-NASD-2003-140, a proposed rule change to adopt new FINRA Rule 5131 (originally proposed as NASD Rule 2712) to address disclosure and management of conflicts of interests that may adversely affect 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. The SEC published the proposed rule change for notice and comment on December 20, 2004 and received twelve comment letters.[5]

FINRA is filing this Amendment No. 3 to address the substantive issues raised by commenters and to clarify and streamline the proposed rule. Among other things, the revisions simplify the spinning provision, clarify the scope of the lock-up disclosure and returned shares provisions and propose several new defined terms.

Proposed Rule 5131(b) - Spinning

FINRA is eliminating the presumption that any allocation within the prior six months of the receipt of investment banking business would violate the spinning provision. Instead, FINRA is proposing an outright prohibition on allocations in certain specified situations where a client relationship exists, where compensation has been received or where a member intends to provide or expects to be retained for investment banking services. Specifically, FINRA is proposing amendments to clarify that the spinning prohibition would apply to allocations to the account of an executive officer or director of a current investment banking client of the member in addition to companies from which the member has received investment banking compensation during the past twelve months. Further, FINRA is proposing to narrow the forward-looking window to three months in order to capture circumstances during such period where the member intends to provide, or expects to be retained by the company for, investment banking services within the next three months.

FINRA is adding Supplementary Material .01 to provide that the spinning prohibition would not apply to allocations of securities that are directed in writing by the issuer, its affiliates or selling shareholders, so long as the member has no involvement or influence, directly or

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5 See Securities Exchange Act Release No. 50896 (December 20, 2004), 69 FR 77804 (December 28, 2004) ("Proposing Release").

indirectly, in the allocation decisions of the issuer, its affiliates or selling shareholders with respect to such issuer-directed securities. In addition, to clarify the scope of the types of accounts to which the spinning restrictions would apply, FINRA is proposing a new defined term "account of an executive officer or director." The proposed definition would mean any account in which an executive officer or director of a company, or a person materially supported by such executive officer or director, has a financial interest or over which such executive officer, director, or materially supported person has discretion or control, other than (A) an investment company registered under the Investment Company Act of 1940 and (B) any other investment fund over which neither an executive officer, director, or materially supported person has discretion or control, provided that executive officers, directors, and materially supported persons collectively own interests representing no more than 25% of the assets of such fund.

Proposed Rules 5131(d)(2)(B) and 5131(d)(3) and (4) - IPO Pricing and Trading Practices

FINRA is proposing to exempt from the notice and disclosure requirements releases and waivers effected solely to permit transfers of securities that are not for consideration where the transferee has agreed in writing to be bound by the same lock-up agreement terms in place for the transferor. FINRA believes that, where the transfer is not for consideration and the transferee is bound by the same terms, the concerns that generally would prompt the need for disclosure under the proposal are mitigated.

In addition, FINRA is proposing to amend the provision addressing the agreement among underwriters, which provides that the agreement between the book-running lead manager(s) 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. Because the allocation concerns underlying the proposed rule only exist where the market price of the returned shares is above the IPO price, FINRA is proposing to amend the proposed rule to provide that the returned shares provision would only be applicable where such shares are trading at a premium to their IPO price. In addition, because a reallocation of returned shares may extend the distribution of the securities for the purposes of SEC Regulation M, FINRA reminds members of their responsibility to undertake reallocations under the proposal in a manner that also is not inconsistent with SEC Regulation M.

FINRA also is proposing to limit the prohibition on the acceptance of market orders to the period prior to the commencement of secondary market trading in the IPO. Therefore, once a trading price on the secondary market has been established, members may accept market orders from customers, even on the first day of trading. FINRA believes that this revised approach strikes an appropriate balance by helping to avoid inadvertent purchases at prices that do not reflect an investor's true investment decision nor reasonable expectations, while limiting the scope and duration of the prohibition to address the pre-open entry of market orders occurring prior to the availability of last trade price information.

Definitions

FINRA is proposing to add a definition of "investment banking services" substantially similar to that found in the research rules. The proposed definition of "investment banking services" would include "acting as an underwriter, participating in a selling group in an offering for the issuer or otherwise acting in furtherance of a public offering of the issuer; acting as a financial adviser in a merger, acquisition or other corporate reorganization; providing venture capital, equity lines of credit, private investment, public equity transactions (PIPEs) or similar

investments or otherwise acting in furtherance of a private offering of the issuer; or serving as placement agent for the issuer."

FINRA also is proposing a definition of "IPO" to mean the "initial public offering of an issuer's equity securities, which offering is registered under the Securities Act of 1933 and as a result of which the issuer becomes a public company." The proposed definition of "public company" means "any company that is registered under Section 12 of the Securities Exchange Act of 1934 or files periodic reports pursuant to Section 15(d) thereof."

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no less than 90 and no more than 180 days following publication of the Regulatory Notice announcing Commission approval.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[6] which require, among other things, that FINRA 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. FINRA believes that the new, specifically targeted provisions in the proposed rule change will aid member compliance efforts and help to maintain investor confidence in the capital markets.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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[6] 15 U.S.C. 78o–3(b)(6).

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The SEC published the proposed rule change for notice and comment on December 20, 2004 and received twelve comment letters.[7] Commenters generally supported rules to address abuses in the allocation and distribution of IPOs, but expressed concerns regarding the operation of specific proposed provisions and requested clarification, as further discussed below.

Prohibition on Abusive Allocation Arrangements

Proposed Rule 5131(a) (originally proposed as NASD Rule 2712(a)) would prohibit a member from offering or threatening to withhold shares it allocates in an IPO as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided

[7] See Letter from Christopher J. Ailman, Chief Investment Officer, California State Teachers' Retirement System (CalSTRS), to Jonathan Katz, Secretary, SEC, dated March 27, 2006; Letter from Christianna Wood, Senior Investment Officer, CalPERS Global Equity, to Jonathan Katz, Secretary, SEC, dated March 13, 2006; Letter from Phil Angelides, California State Teasurer; Michael Fitzgerald, Iowa State Treasurer; Randall Edwards, Oregon State Treasurer; Richard Moore, North Carolina State Treasurer; Alan Hevesi, New York Comptroller; George Philip, New York State Teachers' Retirement System; and Orin S. Kramer, Chairman, New Jersey State Investment Council, to Jonathan Katz, Secretary, SEC, dated December 30, 2005; Letter from Eliot Spitzer, Attorney General, Office of the Attorney General, State of New York, to Jonathan Katz, Secretary, SEC, dated December 30, 2005; Letter from Michael Touff, Senior Vice President and General Counsel, M.D.C. Holdings (MDC), to Jonathan Katz, Secretary, SEC, dated November 1, 2005; Letter from Dixie L. Johnson, Committee Chair, Committee on Federal Regulation of Securities, Business Law Section, American Bar Association (ABA), to Jonathan Katz, Secretary, SEC, dated March 8, 2005; Letter from Edward M. Alterman, Fried, Frank, Harris, Shriver & Jacobson LLP (Fried Frank), to Jonathan Katz, Secretary, SEC, dated February 27, 2005; Letter from John Faulkner, Chairman, SIA Capital Markets Committee, Securities Industry Association (SIA), to Jonathan Katz, Secretary, SEC, dated February 15, 2005; Letter from Ross Langill, to the SEC, dated January 20, 2005; Letter from Mark G. Heesen, President, National Venture Capital Association (NVCA), to Jonathan Katz, Secretary, SEC, dated January 19, 2005; Letter from Renaissance Capital, to the SEC, dated January 18, 2005; and Letter from Dixie L. Johnson, Committee Chair, Committee on Federal Regulation of Securities, and Peter W. LaVigne, Chair, NASD Corporate Financing Rules Subcommittee, Committee on Federal Regulation of Securities, Business Law Section, American Bar Association, to Jonathan Katz, Secretary, SEC, dated January 4, 2005 (available at http://www.sec.gov/rules/sro/nyse/nyse200412.shtml).

by the member (i.e., quid pro quo allocations). While commenters largely supported this proposal as an important safeguard against abusive activity, a few requested clarification with respect to its intended scope.

For example, one commenter requested that the proposal be limited to compensation that is "clearly excessive."[8] FINRA does not support this change and believes that the modifier "clearly" ironically makes the standard less clear as it would introduce uncertainty around what is "excessive" versus "clearly excessive." Moreover, FINRA believes that compensation that is "excessive" is the appropriate standard for establishing improper quid pro quo activities.

Commenters also requested that FINRA provide additional guidance to clarify that, in determining whether or not compensation is excessive, all the facts and circumstances surrounding the services provided will be considered including, among other things, the risk and effort involved in the transaction.[9] A commenter further noted that while some fees can easily be benchmarked, other fees may be more highly negotiated due to the more customized nature of the services provided and this should be considered in determining whether or not a fee is excessive.[10] Commenters also requested that FINRA clarify that trading fees earned from certain wash sale transactions would not be deemed excessive if entered into for a valid purpose.[11]

FINRA agrees that an assessment of whether compensation is excessive will be based upon all of the relevant facts and circumstances including, where applicable, the level of risk and

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8 See SIA.

9 See ABA and SIA.

10 See SIA.

11 See ABA.

effort involved in the transaction and the rates generally charged for such services. Likewise, given that a determination of what is "excessive" compensation will involve a consideration of all the relevant facts and circumstances, FINRA cannot clarify whether or not compensation for a particular wash sale transaction will be deemed excessive. While NASD (n/k/a FINRA) has stated in the Proposing Release that trading activity that serves no economic purpose other than to generate compensation for the member (such as certain wash sales) would be considered excessive, if a wash sale has an economic purpose, that factor will be considered in assessing whether the transaction has an economic purpose, and in turn whether the trading fees for such sales are excessive.[12]

Prohibition on Spinning

Proposed Rule 5131(b) (originally proposed as 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 person, if the member received compensation from the company for investment banking services in the past 12 months or expects to receive or intends to seek investment banking business from the company in the next 6 months. The proposal included a rebuttable presumption that, where a firm allocates IPO shares to an executive officer or director of a company and then subsequently receives investment banking business from that company, the allocations would be deemed to have been made with the expectation or intent to receive such business. Finally, the proposed provision would prohibit allocations made on the express or implied condition that the executive officer or director, on behalf of the company, would direct future investment banking business to the member.

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[12] We note this would not affect the determination as to whether the wash sale transaction violated the anti-fraud provisions of the securities laws.

Commenters generally supported the adoption of a rule that would address the practice of spinning, but expressed concern that the proposal is overbroad and would lead to compliance difficulties.[13] Specifically, commenters opposed the six-month forward-looking presumption in that it would shift the burden of proof to member firms to demonstrate that a past allocation was not part of a quid pro quo arrangement for investment banking business.[14] In addition, commenters were concerned that the length of the presumption had the potential to implicate too many past IPO allocations that were unrelated to a subsequent award of investment banking business.[15] In addition, some commenters proposed that, if adopted, the six-month forward-looking period should be reduced to three months, which is the standard currently required for addressing conflicts of interest in the research analyst rules.[16]

FINRA is proposing to narrow the forward-looking window to prohibit allocations in cases where the member intends to provide, or expects to be retained by the company for, investment banking services over the next three months. FINRA believes that a three month window, combined with the prohibition on allocations based on the express or implied condition that the member will be retained for future investment banking business as set forth in paragraph 5131(b)(3), will sufficiently addresses this conflict of interest.

In addition, FINRA has eliminated the presumption that all allocations within the prior specified period are violations of the rule. Where an executive officer or director receives an IPO allocation and the investment bank is subsequently retained for the performance of

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13 See ABA and SIA.

14 See ABA, MDC and SIA.

15 See ABA.

16 See SIA.

investment banking services within the three-month window by such executive officer or director's employing firm, FINRA will investigate what particular information about the business relationship was known by the firm, including a review of the communications between the broker-dealer and the investment banking client as well as the member's systems for logging and managing prospective and current client and transaction information.

FINRA also is proposing revisions to clarify that the spinning prohibition would apply to allocations to an executive officer or director of a current investment banking client of the member (in addition to companies from which the member has received investment banking compensation during the past twelve months). FINRA believes that, in all cases, allocations to executive officers and directors of existing clients should be prohibited, and that allocations should not be permitted due to the compensation schedule between the client and the member where the business relationship falls within the specified windows.

Commenters also raised concerns regarding the provision prohibiting the allocation of IPO shares to an executive officer or director on the "express or implied" condition that such executive officer or director, on behalf of the company, will retain the member for the performance of future investment banking services.[17] Commenters expressed concern that the prohibition on IPO allocations based on an "implied condition" to retain the member for future investment banking business injects a level of uncertainty that may prevent members from selling IPO securities to executive officers and directors as the result of a legitimate business relationship and, therefore, may interfere with the ability of members to allocate securities to customers.[18] FINRA does not believe that the commenters' concerns warrant a change to the

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17 See ABA.

18 See ABA.

proposed rule. An effective prohibition on spinning must, in FINRA's view, address express as well as implied relationships and arrangements.

Several commenters requested an exemption from the spinning provision for allocations to executive officers and directors that were directed by the issuer ("issuer-directed shares").[19] Commenters believed that, because underwriters do not control these allocations, they do not give rise to the regulatory concerns that the proposed rule change is intended to address.[20] Commenters further noted that issuers have long included their own officers and directors in directed share programs, and that it would be a dramatic departure from that practice if the final rules did not include an exception for issuer-directed shares.[21] Commenters requested that an exception be provided for allocations directed by an issuer, its affiliates or selling shareholders.[22]

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19 See ABA, Fried Frank and SIA.

20 See ABA and SIA.

21 See SIA.

22 See ABA and SIA.

FINRA believes that so long as the member has no involvement or influence, directly or indirectly, in the allocation decisions of an issuer, its affiliates or selling shareholders, allocations directed by such parties should fall outside of the spinning prohibitions. Accordingly, FINRA is adding Supplementary Material .01 to provide that the spinning prohibition would not apply to allocations of securities that are directed in writing by the issuer, its affiliates or selling shareholders, so long as the member has no involvement or influence, directly or indirectly, in the allocation decisions of the issuer, its affiliates or selling shareholders with respect to such issuer-directed shares.

Along with the carve-out for issuer-directed sharers, commenters also requested an exemption for allocations made by a separately organized investment adviser.[23] While FINRA notes that the Voluntary Initiative, in addition to exempting issuer-directed allocations, also exempted allocations directed by a separately organized investment adviser, FINRA is not proposing a similar carve-out for investment advisers. FINRA believes that the purpose of providing an exception for issuer-directed shares is to clarify that, in cases where the member is effecting an allocation made by the issuer, its affiliates or selling shareholders without the direct or indirect involvement or influence of the member, the member would not be prohibited from carrying out such directives. In contrast, where an allocation is being directed by a party other than the issuer (e.g., a separately organized investment adviser), there is a higher risk that improper incentives would motivate such party's decision to allocate shares to the account of an executive officer or director of a company that falls within the purview of the proposed rule. Providing an exception for allocations by separately organized investment advisers would create

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[23] See ABA and SIA.

a significant loophole through which the member and its affiliates may indirectly engage in the same abusive conduct the spinning rule is designed to address.

To comply with the proposed spinning provision, members would be required to determine whether an account is an "account of an executive officer or director" prior to making an allocation of IPO shares in order to avoid violating the rule. Commenters expressed concern regarding the compliance burden of tracking executive officers and directors and those materially supported by them, and requested that the rule be limited to apply only to the officers and directors themselves and immediate family members living in the same household.[24] FINRA believes that limiting the scope of the rule only to relatives residing in the same household is too narrow and could open up means of circumventing the rule. In addition, the proposed definition of "material support" is substantively similar to that found in FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings), with respect to the purchase and sale of "new issue" securities. FINRA believes that members can comply with the proposed provision by developing policies and procedures reasonably designed to identify those persons covered within the scope of the proposed rule. Therefore, FINRA believes that the appropriate scope of the rule is to reach executive officers and directors as well as those who they "materially support."

Commenters also stated that the rule should be limited to officers and directors of a U.S. public company or where the securities of the officer or director's company are principally traded in the U.S.[25] FINRA believes that the proposed prohibitions should apply to member conduct in the area prescribed, irrespective of where the recipient's company is domiciled or in

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24 See ABA and SIA.

25 See SIA.

what jurisdiction the securities of the recipient's company principally trade. Furthermore, spinning abuses also are possible where the recipient's company is not yet a public company, e.g., companies seeking to conduct their first initial public offering are often actively solicited by member firms.[26]

In addition, in order to clarify the scope of the types of accounts to which the spinning restrictions would apply, FINRA is proposing a new defined term "account of an executive officer or director." The proposed definition would mean any account in which an executive officer or director of a company, or a person materially supported by such executive officer or director, has a financial interest or over which such executive officer, director, or materially supported person has discretion or control, other than (A) an investment company registered under the Investment Company Act of 1940 and (B) any other investment fund over which neither an executive officer, director, or materially supported person has discretion or control, provided that executive officers, directors, and materially supported persons collectively own interests representing no more than 25% of the assets of such fund. FINRA believes that the proposed exceptions for registered investment companies and any other fund in which covered persons' collective interests are limited to 25% of the fund's assets will prevent firms from indirectly allocating IPOs to executive officers and directors.

IPO Pricing and Trading Practices

Commenters generally supported the proposals related to IPO Pricing and Trading Practices; however some commenters expressed concern regarding certain provisions. Commenters argued that the notice and public disclosure requirements relating to lock-up agreements would result in a flood of meaningless information and that, therefore, at a minimum,

[26] FINRA notes, however, that the proposed new definition of an "IPO" (discussed below) is limited to the securities of a U.S. registered company.

only the release of a significant amount of shares should be required to be disclosed.[27] Commenters also requested that FINRA require notification two days prior to the "sale" rather than the "release" or "waiver" of a lock-up.[28]

FINRA continues to believe that public disclosure should be required for releases and waivers permitting the transfer of securities subject to a lock-up agreement, and that such disclosure should be made two business days prior to the impending release. However, FINRA is proposing to exempt from the notice and disclosure requirements releases and waivers effected solely to permit a transfer of securities that are not for consideration and where the transferee has agreed in writing to be bound by the same lock-up agreement terms in place for the transferor. Where the transfer is not for consideration and the transferee is bound by the same terms, the concerns that generally would prompt the need for disclosure under the proposal are mitigated.

Commenters requested that FINRA permit the disclosure of the required information through any method permitted under SEC Regulation FD.[29] A commenter also requested that FINRA clarify that the natural expiration of a lock-up need not be preceded by a public announcement where such expiration is disclosed in the IPO prospectus.[30]

FINRA believes that any news service used by issuers for providing public disclosure of material information pursuant to SEC Regulation FD would satisfy the proposed rule's requirement that public disclosure be made "through a major news service." FINRA also agrees that notice and public disclosure is not necessary for the natural expiration of a lock-up already

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27 See ABA and SIA.

28 See generally ABA and SIA.

29 See ABA and SIA.

30 See SIA.

disclosed in the prospectus. However, FINRA does not believe that it is necessary to make these clarifications in the rule text.

One commenter requested that FINRA clarify that the notice requirement would be fulfilled by providing an announcement to a major news organization irrespective of whether the news organization ultimately publishes the announcement.[31] FINRA believes that, as required pursuant to Regulation FD, it is important that members utilize a method (or combination of methods) of disclosure reasonably designed to provide broad, non-exclusionary distribution of the required information to the public.[32] Therefore, in announcing the required information, members are expected to select a method that is likely to result in the actual public dissemination of the specified information.

Commenters also expressed concern regarding the proposed requirements applicable to returned shares.[33] The proposal provides that the agreement between the book-running lead manager(s) 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. Commenters expressed concern that the proposal does not provide an alternative to address cases where the current market price is lower than the public offering price, making allocating shares to unfilled indications of interest inappropriate.[34] FINRA believes that

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31 See SIA.

32 See 17 C.F.R. § 234.101(e)(2).

33 See ABA and SIA.

34 See ABA and SIA.

if the current market price of returned shares is below the IPO price, then the concerns underlying the proposed rule are non-existent, as the ability to purchase at the public offering price does not confer an economic benefit. Accordingly, FINRA proposes to amend the proposed rule change to apply the returned share provisions only to shares that are trading at a premium to their IPO price.

Commenters further requested clarification regarding the requirements for returned shares. Commenters argued that certain scenarios should be exempted from the rule, including where the securities returned were the subject of a bona fide sale but the investor failed to pay for the securities.[35] FINRA disagrees and does not believe that the circumstance under which IPO shares are returned to the firm should influence whether the firm can then award them to favored customers. The proposed rule change, as amended, addresses the potential conflicts of the member in awarding a customer shares at the IPO price when they are already trading at a premium on the secondary market; the manner and circumstances surrounding the return of the shares does not alter the analysis as to how the member should proceed with a reallocation.

Commenters also raised concern that the reallocation of shares subsequent to the commencement of aftermarket trading may be considered to be new sales of securities that continue the distribution of the IPO shares with the result that members' market-making purchases in the aftermarket may be deemed to be in violation of SEC Regulation M.[36] FINRA has revised the proposed rule change to specifically address the need to comply with SEC Regulation M, and FINRA intends to work with SEC staff in applying the proposed rule change in a manner that does not conflict with Regulation M.

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35 See ABA and SIA.

36 See ABA.

The proposed rule change also provides that no member may accept a market order for the purchase of IPO shares during the first day that the IPO shares commence trading on the secondary market. Commenters expressed concern that this provision would increase volatility in secondary market trading and also would be technologically cumbersome and costly for members to implement.[37] As discussed in the Proposing Release, the IPO Report noted that IPOs are inherently more volatile than stocks with a public trading history. In addition, FINRA notes that institutional investors have generally relied on limit orders for IPOs in the aftermarket. FINRA also notes that market orders may result in an investor inadvertently purchasing a security at prices that neither reflect their true investment decisions nor their reasonable expectations. Such complaints were not uncommon during the market bubble that led the IPO Advisory Committee to make this recommendation.

FINRA notes that technological advancements since the time of the initial filing have resulted in improved access to real-time price information, making it less likely that a customer's market order would result in the purchase of a security at a price that is unrelated to the customer's expectations. Thus, FINRA proposes to modify the prohibition on the acceptance of market orders to apply only to orders entered prior to the commencement of secondary market trading in an IPO. FINRA believes that this revision more precisely focuses the rule to the time posing greatest potential for investor harm.

Definitions

Commenters requested several amendments to the definitional section with respect to certain terms used in the proposal. Commenters requested that a definition of "investment

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[37] See SIA.

banking services" be added and that such definition be based on the research analyst rules.[38] In response to comments, FINRA is proposing to add a definition of "investment banking services" that is substantially similar to that found in the research rules. The proposed definition of "investment banking services" would include "acting as an underwriter, participating in a selling group in an offering for the issuer or otherwise acting in furtherance of a public offering of the issuer; acting as a financial adviser in a merger, acquisition or other corporate reorganization; providing venture capital, equity lines of credit, private investment, public equity transactions (PIPEs) or similar investments or otherwise acting in furtherance of a private offering of the issuer; or serving as placement agent for the issuer."

One commenter requested that, if a definition of "investment banking services" were adopted, it should be limited to U.S. registered offerings.[39] FINRA disagrees that the proposed rule should permit abusive IPO allocation arrangements in exchange for compensation for investment banking services in an overseas transaction (which may involve an affiliate of the U.S. member). In such cases, the same or similar potential conflicts of interest and problematic incentives apply both for the member as well as for the executive officers and directors and should not be permitted.

Commenters supported the addition of definitions for the terms "initial public offering" and "public company."[40] In response to comments, FINRA is proposing to add a definition of "IPO" to mean the "initial public offering of an issuer's equity securities, which offering is registered under the Securities Act of 1933 and as a result of which the issuer becomes a public

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38 See ABA and SIA.

39 See ABA.

40 See generally ABA and SIA.

company." The proposed definition of "public company" means "any company that is registered under Section 12 of the Securities Exchange Act of 1934 or files periodic reports pursuant to Section 15(d) thereof." These proposed definitions are identical in scope to the corresponding definitions found in the Voluntary Initiative.

III. Date of Effectiveness of the Proposed Rule Change 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 self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Additional Comment

We seek specific comment on whether there are any alternatives to the proposed rule change that FINRA should consider, such as whether proposed new Rule 5131(b)'s spinning provision should be modified to include a mandatory ban prohibiting members from seeking or providing investment banking services to a company for a period of 12 months following any allocation of IPO shares to an account of an executive officer or director of such company and whether such a ban would facilitate compliance.

V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2003-140 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2003-140. 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 Web site viewing and printing in the Commission's Public Reference Room,100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. 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-NASD-2003-140 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[41]

Florence E. Harmon
Deputy Secretary

[41] 17 CFR 200.30-3(a)(12).