February 15, 2005

Via E-Mail—rule-comments@sec.gov

Mr. Jonathan G. Katz,
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W., Stop 6-9
Washington, D.C. 20549

Re: Amendments to Regulation M (File No. S7-41-04) and Proposed Rule Changes by Self-Regulatory Organizations Relating to Allocation and Distribution of Shares in Initial Public Offerings (File Nos. SR-NYSE-2004-12 and SR-NASD-2003-140)

Dear Mr. Katz:

The undersigned individuals and organizations (collectively, the "Commenters") appreciate the opportunity to submit this response to Release Nos. 33-8511 and 34-50831 ("Proposed Regulation M") and Release No. 34-50896 (the "Proposed SRO Rules"), particularly as to the way in which Proposed Regulation M and the Proposed SRO Rules interrelate with regard to penalty bids and the internal compensation structures of syndicate members in an initial public offering (an "IPO").

Although the Commenters applaud the self-regulatory organizations (the "SROs") and the Commission for their efforts to create equitable treatment for brokers selling to retail and institutional investors who "flip" their shares within 30 days of an IPO, the Commenters are concerned that the interrelation of Proposed Regulation M and the Proposed SRO Rules will lead to a situation in which retail investors are at a greater disadvantage in the IPO allocation and distribution process than they are under the current regulatory scheme. Specifically, the Commenters are concerned that syndicate members will be unable to discipline their brokers whose customers (both retail and institutional) flip their shares in an IPO, thereby making the managing underwriter's market stabilization efforts difficult and expensive, and potentially negatively affecting the long-term investors who do not flip their shares. The Commenters are concerned that the ultimate consequence of the proposed amendments will be to further limit the distribution of shares in an IPO, especially to retail investors who are the customers of regional investment firms.

I. The Interrelation of Proposed Regulation M and the SRO Proposed Rules

As the Commission noted in its most-recent request for comments on the SRO Proposed Rules, Proposed Regulation M's proposed amendments to the current regulatory scheme create certain consequences and seeming inconsistencies when read in conjunction with the SRO Proposed Rules. Rule 100 of the current Regulation M defines a "penalty bid" as the practice of a managing underwriter reclaiming a selling concession from a syndicate member when "the securities originally sold by the syndicate member are purchased in syndicate covering transactions." Although not addressed by current Regulation M or Proposed Regulation M, similar penalties, related to a syndicate member's internal compensation of its brokers, are often levied by syndicate members on their brokers whose customers flip shares in an IPO or secondary offering; the syndicate member reclaims the broker's commission for the shares that are flipped (an "Internal Penalty").

The SRO Proposed Rules limit the use of Internal Penalties by requiring that an Internal Penalty not be assessed by a syndicate member in an IPO against a broker whose customer flips the shares allocated to that customer within 30 days of the initial offering unless the managing underwriter has assessed a penalty bid "on the entire syndicate." The SRO Proposed Rules stem from the very real concern that Internal Penalties are assessed inequitably more often against brokers selling to retail clients than on brokers selling to institutional investors. A further concern is that, due to the probability of an Internal Penalty being assessed against a retail broker, such broker will exert inappropriate influence on his or her retail customers to hold shares acquired in an IPO, thereby influencing the retail customers' investment decisions based upon reasons other than the investment merits of the securities. The Commenters agree that brokers should not exert undue influence on a client to hold or sell shares based upon the broker's financial risk in the particular transaction; the Commenters believe that investment firms should discipline any broker so influencing clients. However, the Commenters contend that investment firms must also be allowed to institute Internal Penalties against brokers, both retail and institutional, who fail to place shares with appropriate investors. Since shares are typically allocated to the branch office, not the individual broker, an undisciplined broker may prevent an entire branch from receiving an allocation based on the fear that the shares allocated may be flipped. Instead of limiting the inequitable treatment that might lead brokers to exert inappropriate influence on retail customers, the SRO Proposed Rules attempt to deal with this issue by limiting the situations in which such inequitable treatment—and the resulting influence that might be exerted on retail customers—can occur. The SRO Proposed Rules allow syndicate members to use Internal Penalties only when the managing underwriter issues a penalty bid against the entire syndicate. By completely prohibiting managing underwriters' use of penalty bids, Proposed Regulation M causes an unintended consequence to the SRO Proposed Rules by completely eliminating Internal Penalties in an IPO. The Commenters urge the Commission to remember the law of unintended consequences in its consideration of the SRO Proposed Rules and Proposed Regulation M.

II. Effects of the Interrelation of Proposed Regulation M and the SRO Proposed Rules

The result of the interrelation of Proposed Regulation M and the SRO Proposed Rules is to completely eliminate the use of Internal Penalties in IPO's. The positive effect of this result is the elimination of differentiation between retail and institutional investors and brokers, thereby limiting the possibility of a broker imposing inappropriate influence on his or her retail customers as a result of the broker's risk of an Internal Penalty from a syndicate member; however, it also produces the undesirable consequence of negatively affecting retail investors who desire to invest in IPO's, which is the very constituency the Proposed SRO Rules seek to protect. If Internal Penalties are eliminated, the cost of market stabilization for managing underwriters will dramatically increase, and long-term investors (as opposed to those who are short-term holders) will be at greater risk for loss. This economic reality will undoubtedly lead managing underwriters to make changes in the way they structure syndicates for IPO's. Inevitably, this new reality for IPO syndicates will stifle the broad distribution of shares, as regional investment firms, now unable to as effectively police their brokers, are excluded from IPO syndicates. The Commenters fear that the larger wire house firms will exclude regional investment firms from their syndicate groups, citing as the reasons the increased risks and the cost of stabilization and market fluctuation. We cite as but one example an IPO in which one of the syndicate members participated in the underwriting of $18,613,625 of the securities. During the course of the offering, $12,822,000 of those shares were sold back into the market within 30 days of allocation by the initial purchaser, or "flipped." Due to the flipping of these shares, the cost of stabilization was greater, and the success of the offering was jeopardized. Investors, both retail and institutional, were put at risk by the flood of shares back into the market and the potential for substantial price decline. This syndicate member failed to control how its brokers placed these shares, and as a result, managing underwriters may exclude the syndicate member from future offerings. If the Proposed SRO Rules and Proposed Regulation M eliminate the Internal Penalty as a means for a syndicate member to reverse the incentive for its brokers to allocate shares to inappropriate investors, many more syndicate members may be excluded from IPO's. As regional investment firms, with their strong retail investor bases, disappear from IPO syndicates, retail investors' participation in IPO's will cease or, at a minimum, be significantly impaired.

The goal of the issuer, the managing underwriter, the syndicate member and the broker should be the purchase of IPO shares by long-term investors, not speculative short-term holders. Brokers should know their customers and know whether a customer is an appropriate investor for an IPO; however, without the threat of an Internal Penalty, brokers are not financially incented to sell only to appropriate accounts. Rather, without the threat of Internal Penalties, brokers stand to profit from placing IPO shares in the hands of their customers who are not seeking a long-term investment but who are interested in a quick sale of the shares, with the broker receiving the commission on the sale. The syndicate member's ability to penalize its brokers helps to reverse the brokers' financial incentive to sell to customers who might flip shares of an IPO. This, in turn, makes the managing underwriter's attempts at market stabilization more effective, and it ultimately protects long-term investors from market instability due to flipping. In the absence of effective market stabilization by managing underwriters, retail investors become even less likely to participate in IPO's.

If syndicate members cannot rein in their own brokers in part by relying on the penalty bid, the increased costs of market stabilization that will result will inevitably lead managing underwriters to exclude investment houses—especially those regional firms with larger numbers of retail customers—from their IPO syndicates. This will limit the breadth of IPO share distribution throughout the investment community, and it will especially reduce distribution to the retail investors whom these regional investment firms serve in large numbers. Accordingly, while protecting retail investors from inappropriate influence from brokers fearful of Internal Penalties, the interrelation of Proposed Regulation M and the Proposed SRO Rules will lead to the increased exclusion of retail investors from the IPO market. Indeed, the Proposed SRO Rules and Proposed Regulation M have the unintended consequence of working to protect retail investors from the market by effectively excluding them from the IPO market.

III. Recommendations Regarding the Interrelation of Proposed Regulation M and the Proposed SRO Rules

While the Commenters do not presume to compose a regulatory scheme for the SROs or the Commission, they do **suggest that Proposed Regulation M and the Proposed SRO Rules be modified to allow for the continued use of Internal Penalties while requiring that these Internal Penalties be levied in such a way that there is no differentiation with regard to Internal Penalties in the treatment of brokers selling to retail and institutional customers.** The Commenters believe that such a modification would address the concerns that the SRO's outlined in proposing the Proposed SRO Rules while also protecting retail investors' roles in IPO's.

Thank you for this opportunity to comment on Proposed Regulation M and the Proposed SRO Rules as they relate to Internal Penalties. Should you have any questions about this comment letter, please feel free to contact ________________________________.

Kind regards,

\s\ T. Richard Kendrick, IV
Senior Managing Director Equity Capital Markets
Stifel Nicolaus & Company, Incorporated
501 North Broadway
St. Louis, MO 63102

\s\ Lisa J. Schultz
Executive Vice President;
Co-Head Capital Markets
Ryan Beck & Co.
18 Columbia Turnpike
Florham Park, NJ 07932