FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP

One New York Plaza
New York, NY 10004-1980
Tel: 212.859.8000
Fax: 212.859.4000
www.friedfrank.com

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Writer's Direct Line
TEL: 212.859.8104
FAX: 212.859.8589

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Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street
Washington, D.C. 20549-0609

Re: File SR-NYSE-2004-12 and SR-NASD-2003-140
Proposed Rule 2712 Relating to the Allocation and Distribution of Shares in Initial Public Offerings

Dear Sir:

We appreciate the opportunity to comment on NASD Proposed Rule 2712 relating to the allocation and distribution of shares in initial public offerings (IPOs).[1]

Spinning - Proposed NASD Rule 2712(b) would prohibit an NASD member from allocating shares in an IPO to an executive officer or director, or the immediate family of an executive officer or director, of a company with which the NASD member has or expects to have an investment banking relationship. The purpose of this provision is "to ensure that [NASD] members avoid unacceptable conduct when they engage in the allocation and distribution of IPOs."[2] Such a purpose accords with the traditional concern that NASD members not allocate shares to persons as an inducement to award investment banking business to the member, or as a reward for having done so in the past. This practice of spinning has been the subject of much discussion, and is within the authority of the NASD to prohibit. However, we believe that the proposed rule is overbroad, even in light of the perceived severity of the problem. While a rule that prohibits spinning may be deemed to be desirable, a rule which seeks to prohibit a large category of transactions simply to eliminate the possibility that a few persons will seek to circumvent a rule against spinning is regulation gone too far, especially since, by the NASD's own admission, spinning is already prohibited by existing law and rules. It also raises fundamental questions of fairness to corporate officers and directors, and even more so to members of their immediate families, who would otherwise legitimately be eligible to receive shares in an IPO based on whatever factors an NASD member might establish for such

1 While the discussion *supra* references Proposed NASD Rule 2712, the discussion is equally applicable to Proposed NYSE Rule 470 insofar as those provisions are identical.

2 See the NASD's Statement of Purpose, File No. SR-NASD-2003-140, dated December 9, 2003.

allocations to its customers, when there is no intent by either the customer or the member to engage in spinning. We therefore submit that, to the extent that additional rulemaking is deemed advisable, a simple provision that prohibits the allocation of IPO shares in the expectation of receiving, or in return for, investment banking business, is the appropriate way to address the issue.

Even if a rule containing a general prohibition on allocation of shares to executive officers and directors is needed, we believe that there are ways to make proposed Rule 2712(b) less onerous without effecting its investor protection purpose. That provision, as proposed, would obviously and directly affect issuers who, as part of the issuer's IPO, direct one or more of the underwriters of the offering to allocate shares to, *inter alia*, the issuer's officers, directors and employees, since by definition the NASD member will have or expect to have an investment banking relationship with the issuer by reason of underwriting the issuer's IPO. Since the purpose of the proposed provision is to prevent NASD members from using the allocation process in improper ways, that purpose is not aided when, as is the case with issuer-directed shares, someone other than the NASD member decides who will receive the IPO shares. This is equally true if the issuer wishes to direct shares to officers or directors of other companies, such as affiliated companies or companies with which the issuer does business.

In addition, the NASD has previously stated that issuer directed share programs "are a valuable tool in employee development and retention", and that "issuers should be free to set the conditions for sales of their own securities to their own employees."[3] The rule, as proposed, would frustrate, at least to a certain extent, the benefits of a issuer-directed share program by preventing the issuer from directing shares to its officers and directors, and the officers and directors of affiliates and companies with which the issuer does business, persons who presumably are among those the issuer would most like to have purchase shares in the IPO.[4]

Finally, the restrictions imposed by proposed Rule 2712(b) are inconsistent with the provisions of Rule 2790 (as well as IM-2110-1 which it replaced) which allows the sale of IPO securities to otherwise prohibited persons who are employees, officers or directors, or the immediate family members of such persons, provided that the shares are directed by the issuer to such persons.[5] This inconsistency is especially noteworthy, since the NASD has stated that "[u]nder the proposed rule change [Rule 2712(b)], 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 (or in proposed Rule 2790 once it is adopted, which will replace the Interpretation)."[6] Under the Interpretation and Rule

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3 See letter from Gary L. Goldsholle, Assistant General Counsel, NASD, to Katherine A. England, dated December 20, 1999, in support of Amendment No. 1 to then proposed Rule 2790.

4 This firm has represented the underwriters coordinating the issuer-directed share program in several hundred IPOs. In every such case the issuer directed the underwriters to reserve shares for its officers and directors.

5 See Rule 2790(d).

6 See File No. SR-NASD-2003-140, dated September 15, 2003.

2790, sales to officers and directors of the issuer and its affiliates are allowed, although they would be prohibited by proposed Rule 2712(b). Sales of issuer-directed shares to officers and directors would also be allowed by the terms of the *Voluntary Initiative Regarding Allocations of Securities in "Hot" Initial Public Offers to Corporate Executives and Directors* entered into by the participating firms[7] and provided to the S.E.C., NASD, the New York Stock Exchange, the Attorney General of New York and the North American Securities Administrators Association in connection with the investigation into research analyst conflicts of interest[8].

It should also be noted that the application of proposed Rule 2712(b) to issuer directed share programs would be internally inconsistent with proposed Rule 2712(e)(2)(A), which provides that any lock-up or restriction on the transfer of an issuer's shares to which officers and directors of the issuer are subject will also apply to any issuer-directed shares such persons purchase. That provision would be meaningless, since proposed Rule 2712(b) would prevent such individuals from purchasing issuer-directed shares in the first place.[9]

In summary, the application of proposed Rule 2712(b) to issuer directed share programs would not advance the purposes of the rule, would frustrate in part the beneficial aspects of such programs to the issuer, and would be inconsistent with Rule 2790(d) and proposed Rule 2712(e)(2)(A). Accordingly, we respectfully request that if the proposed rule is to contain a prohibition on allocations to executive officers and directors, a new subsection be added to proposed Rule 2712(b) to provide that:

> "The prohibitions of this section shall not apply to shares which are specifically directed by the issuer to such persons, provided that no member firm has asked or otherwise suggested to the issuer that securities be directed to such persons."

Broken Trades – Proposed NASD Rule 2712(e)(3) would have the effect of requiring that if, after the aftermarket begins and the shares are trading at less than the public offering price, a purchaser returns shares to a syndicate member, the syndicate member may either retain the shares or sell them into the market and suffer the loss. This may be consistent with the concept that if a member chooses to do business with a client, that decision also includes the assumption of risk of non-performance by the client. However, that concept is inapplicable in the case of an issuer-directed share program, where the offerees are chosen not by the NASD

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7 The participating firms are Bear, Stearns & Co. Inc., Citigroup Global Markets Incorporated, Credit Suisse First Boston LLC, Deutsche Bank Securities Inc., Goldman, Sachs & Co., J.P. Morgan Securities Inc., Lehman Brothers Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co. Incorporated, UBS Warburg LLC [now UBS Securities LLC] and U.S. Bancorp Piper Jaffray Inc.

8 Moreover, the *Voluntary Initiative* only prohibits sales of IPO shares to executive officers and directors of ***public*** companies.

9 Only broker-dealers participating in an issuer's initial public offering are able to sell the issuer's shares, and they are, by definition, already in an investment banking relationship with the issuer.

member, but by the issuer. That is why the risk of broken trades is, pursuant to contractual agreement, borne by the issuer in a directed share program.[10] Indeed, since NASD members conduct these programs as an accommodation to the issuer, and do not charge for doing so, to force the members to bear the risk of non-performance by the offerees selected by the issuer would be unfair, and might lead some NASD members to refuse to conduct such programs. Additionally, if the NASD member could not look to the issuer in a directed share program to recoup the loss of a broken trade, then the member's only redress for broken trades is the traditional contractual right to bring a proceeding against the purchaser who broke the trade. In most if not all cases, the issuer would prefer not to have the member proceed against the person who the issuer invited to participate in the program, since such an action would surely vitiate the good will toward the issuer engendered by the invitation. We feel that this should be a matter of contractual agreement between the issuer and the member. Accordingly, we respectfully suggest that the following sentence be added to proposed Rules:

> "However this subparagraph (3) shall not prohibit the enforcement of an agreement by the issuer to indemnify a member for any loss suffered by reason of the failure of a person to whom shares have been directed by the issuer to pay for and accept delivery of issuer directed securities which were the subject of a properly confirmed agreement to purchase."

Again, we appreciate the opportunity to comment on the proposed rules. If you have any questions about the foregoing, or wish further discussion of the issues raised herein, please do not hesitate to call me at (212) 859-8104 at any time.

Very truly yours,

/s/

Edward M. Alterman

EMA:bst:571299

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[10] We have represented at least four NASD members in connection with issuer directed share programs, involving hundreds of such offerings. We are unaware of any issuer directed share program where the NASD member has borne this risk of non-performance.