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February 15, 2005

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington DC 20549

Re: File Nos. SR-NYSE-2004-12; SR-NASD-2003-140;
IPO Allocations & Distributions

Dear Mr. Katz:

The Capital Markets Committee of the Securities Industry Association ("SIA")[1] appreciates the opportunity to comment on the proposed rules of the New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD) relating to IPO allocations and distributions.[2]

We support the efforts of the NASD and NYSE to address specific issues of concern in connection with the Initial Public Offering ("IPO") process. The SROs are to be commended for their leadership in targeting such concerns as early as 2002.[3] These rule proposals also follow up on recommendations included in the Report of the NYSE/NASD IPO Advisory Committee (" IPO Report"),[4] which SIA praised when it was released in May of 2003. While suggesting specific targeted reforms, the IPO Report recognized that our capital raising system is the most successful in the world and is the engine for our country's economic growth, enabling companies to raise the capital they need to expand.

For the most part, we believe that the specific rulemaking proposals included in the rule filing offer useful suggestions to further the objective of enhancing public confidence in the integrity of the IPO process. However, with respect to parts of the proposal that have been revised since we last commented, we have some substantive concerns. We address each part of the proposal in turn below.

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[1] The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry employs 790,600 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated $213 billion in domestic revenue and an estimated $283 billion in global revenues. (More information about SIA is available at: www.sia.com.)

[2] Securities Exchange Act Release No. 50896 (December 20, 2004), 69 Fed. Reg. 77804.

[3] NASD Notice to Members 02-55.

[4] NYSE/NASD IPO Advisory Committee, Report and Recommendations, (May 2003).

1. **NASD Rule 2712(a); NYSE Rule 470A – Prohibition on allocations in exchange for excessive compensation**.

The proposed rule would 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.

COMMENT - SIA supports the provision. The proposal properly identifies a specific allocation practice to be prohibited without unintentionally interfering with legitimate activities of underwriters and without imposing unnecessary costs and burdens on NASD and NYSE member firms. SIA believes the proposal should be limited to compensation that is "clearly excessive" and, in any event, could benefit from some clarification of "excessive." For example, fees received for executing "commodity" type services such as executing secondary market trades can easily be benchmarked, whereas fees for other services are more highly negotiated because the services provided are much more customized. In order to provide members with guidance as to how the NASD and NYSE would define "excessive," SIA suggests adding language clarifying that a determination of whether compensation is "excessive" should take into account all of the circumstances surrounding the services provided, including but not limited to the uniqueness, creativity, risk and effort involved in the transaction or transactions, as well as the totality of the relationship between the customer and the member.

SIA believes that the NASD needs to make it clear in rule language that "IPO" means a U.S.-registered IPO. This would make the definition consistent with the definition of IPO in the NYSE proposal.

2. **NASD Rule 2712(b); NYSE Rule 470(B) – Prohibition on Spinning**.

As originally proposed by the NASD, this rule would expressly prohibit 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. SIA and the NYSE/NASD IPO Advisory Committee supported this provision.

The rule proposal has been amended to preclude allocations to executive officers or directors of a company if the member (i) has received compensation from the company for investment banking services in the past 12 months, or (ii) expects to receive or intends to seek investment banking business from the company in the next six months.

The proposed rule change also adds a provision stating that an expectation to receive or intent to seek investment banking business will be presumed where a member firm receives investment banking business from a company within six months following an IPO allocation to an officer or director of the company. A member could rebut this presumption with evidence that the allocation of IPO shares was not made with such an expectation or intent.

COMMENT - SIA supports the adoption of a properly tailored rule addressing spinning concerns, but believes the current proposal would be unfair to member firms, inconsistent with policies and system solutions already implemented by firms to address these concerns, and unnecessarily difficult and costly to implement. SIA recommends instead that the NASD and NYSE adopt the original rule language proposed in NTM-02-55 as described above. If the original rule language is not adopted, then SIA believes that the SROs should adopt a bright line rule that tracks the approach taken in the Voluntary Initiative. We do not believe that the SROs should take the approach suggested in the current proposal for the reasons discussed below.

a.) Original NTM-02-55 Language. SIA believes that the original language of proposed Rule 2712(c) was well-tailored to address spinning concerns. Spinning, as defined in the report of the NYSE/NASD IPO Panel, is the allocation of IPO shares to directors or executives of investment banking clients in exchange for investment banking business. Spinning occurs only if the allocation is conditioned on or made in exchange for investment banking business – in other words, if there is a quid pro quo. The NASD's original language would give rise to a violation only where an IPO allocation is conditioned on, or is provided as consideration for, banking business. This language properly identified a specific allocation practice to be prohibited without unintentionally interfering with legitimate activities of underwriters and without imposing unnecessary costs and burdens on NASD member firms.

b.) Voluntary Initiative Approach. Alternatively, if the NASD's original rule language is not adopted, SIA would urge the Commission to adopt a bright line ban on allocations to certain parties based on the language in the Voluntary Initiative.[5] The Voluntary Initiative prohibits allocations of shares in SEC-registered IPOs to executive officers or directors of U.S. public companies or public companies for which a U.S. market is the principal equity trading market. While the Voluntary Initiative sweeps more broadly than the NASD's original NTM-02-55 language, prohibiting allocations even where there is no quid pro quo linking an allocation to the receipt of investment banking business, it has the virtue of being a clear, bright line approach that has already been implemented by many member firms. The provisions of the Voluntary Initiative were painstakingly negotiated over the course of a year by broker-dealer firms with the SEC, NYSE, NASD, NASAA and New York Attorney General's Office, and thus reflect the views of both leading representatives of the industry and also a large and authoritative group of state and federal regulators.

SIA notes that the current proposal is broader than the Voluntary Initiative in a number of respects. For example, the current proposal would prohibit allocations to

[5] Voluntary Initiative Regarding Allocations of Securities in "hot" Initial Public Offerings to Corporate Executives and Directors. (http://www.sec.gov/news/press/globalvolinit.htm)

executive officers and directors of any company located anywhere in the world, while the Voluntary Initiative is limited to companies that file periodic reports with the Commission (and disclose the names of their executive officers and directors in certain of those filings). The current proposal would also define "immediate family member" more broadly than the Voluntary Initiative. Thus, the current proposal would require a separate and overlapping compliance regime from the one already in place. This would be costly and time consuming to build and it is not clear what benefits would be obtained beyond those that have already been achieved under the Voluntary Initiative. It would also require investors to provide their brokers with yet another set of representations (in addition to those already provided under the Voluntary Initiative and NASD Rule 2790) in order to participate in IPOs. If the representations addressed some new and different regulatory concern then the additional burden might be warranted, but it is difficult to justify placing this additional burden on investors when it is meant to address the exact same set of concerns already addressed in the Voluntary Initiative.

c.) Current Proposal – Concerns and Suggestions. As noted above, SIA does not support adoption of the current proposal relating to spinning, and we have very significant concerns with some aspects of the proposal. Our concerns and suggestions are discussed below.

SIA is especially troubled by the proposed presumption of an expectation to receive or intent to seek investment banking business in the current proposal. We believe that the presumption is unfair and overreaching because, notwithstanding steps that member firms have taken in recent years to prevent investment banking personnel from having input into allocation decisions relating to individual investors, and notwithstanding the provisions of the Voluntary Initiative expressly prohibiting such input, the proposals would assume the existence of a violation *unless* proven otherwise. The presumption would fundamentally shift the burden of proof to member firms to demonstrate that a past allocation is *not* part of a quid pro quo arrangement for investment banking business. The receipt of an investment banking mandate should not retroactively taint a prior allocation in the absence of evidence of such an arrangement. Given that the purpose of the proposed rules is to prevent the use of allocations to secure investment banking business, it is alarming to think that a violation could be found automatically and retroactively without any proof of intent to engage in such spinning activities. The determination of whether an allocation is a part of an illicit spinning scheme should continue to be based on a facts and circumstances assessment and an illegitimate purpose should not be assumed from an allocation to a good client. Finally, it is significant that neither the Voluntary Initiative nor the IPO Report recommended a presumption of a violation based on future business transactions of the member.

The proposal's presumption could, in effect, disqualify a broker-dealer who has made an allocation from obtaining an investment banking mandate, even where there is no connection whatsoever between the allocation and the later interest of the company in retaining the services of the broker-dealer. Issuers could find their access to capital impaired if they are unable to work with an underwriter that has experience and knowledge of the issuer's capital needs or specializes in the type of transaction that the issuer is seeking.

If, despite these strong concerns, the Commission and the SROs retain the proposed presumption, SIA suggests at a minimum that the SROs establish a safe harbor from the presumption using the procedures described in the proposing release as evidence that could be used to rebut a presumption. The safe harbor would require that the underwriter establish that it has procedures reasonably designed to ensure that investment banking personnel responsible for making allocations are not told the identities of the beneficial owners of retail accounts (i.e., accounts not included in the institutional "pot") to which shares are being allocated.

SIA also has a major concern with the difficulty of implementing the proposed rule. The rule would prohibit an allocation if the investor is an executive officer or director of a company *and* the company is an investment banking client of the member firm. Member firms would not only need to track the names of companies that are investment banking clients but also, for each individual investor client of the firm, the name or names of every company that the individual investor serves as an executive officer or director. And firms would then need to build systems that could match the two sets of data on a rolling basis in order to block only those investors where a company name appears both as a banking client and in the database for the particular investor. This would require a very sophisticated and costly systems solution. Given the difficulty of collecting and tracking this information, particularly on the individual investor side, and matching it on a rolling basis with the names of investment banking clients, member firms might choose to implement a flat ban instead. In other words, firms might simply ask each individual investor client whether he or she is an executive officer or director of a company (and not attempt to track and match the names of the companies), and then block all those investors who answer in the affirmative.

SIA also has a number of other concerns with the proposal. SIA believes that the period of time in the prospective part of the rule should be changed to three months from the proposed six and the description of the relationship that triggers the requirement should be modified to refer to "compensation for investment banking services." This would conform the proposed rule to the language in the NYSE/NASD research rules. Firms already track issuers from whom they expect to receive or intend to seek banking compensation in the next three months for purposes of the disclosure provisions of the research rules.[6] The research rules apply where the member firm "expects to receive or intends to seek compensation for investment banking services," whereas the proposed rule would apply where the member firm "expects to receive or intends to seek investment banking *business*." There would seem to be little reason to require member firms to track a different time period and a slightly different relationship in the context of the proposed rule. Member firms could avoid significant development work and expense

[6] See NASD Rule 2711(h)(2)(A)(ii)(c).

by using the same standard in this rule as is already tracked for purposes of the research rules.

SIA also believes the rule ought to include an exception for allocations of shares that are directed by an issuer, its affiliates, selling shareholders or a separately organized investment adviser. Because underwriters do not control these allocations, they do not give rise to the regulatory concerns that the proposed rule is intended to address. And because IPO issuers view it as within their discretion to allocate a portion of the IPO to investors of their choosing, underwriters are not in a position to impose a different outcome. In fact, issuers have included their own officers and directors in directed share programs for many years, and it would be a dramatic departure from that longstanding practice if the final rules do not include an exception for directed shares. SIA also notes that the Voluntary Initiative includes an exception for allocations directed by an issuer, its affiliates, selling shareholders or an investment adviser, and we believe it is critical for any new restriction to include a similar exception.

SIA also recommends precisely defining accounts that may not receive allocations in a manner consistent with the definition used in the Voluntary Initiative. That definition - “an account of an executive officer or director of a U.S. public company or a public company for which a U.S. market is the principal equity trading market” – is already being used by member firms to track accounts for purposes of compliance. Banning allocations to all persons who may be an officer or director of any company, located anywhere in the world, large or small, public or private, is not just logistically impracticable for member firms to track, but could materially and negatively impact the available pool of potential purchasers for IPOs.

SIA believes that associated persons of a member firm should only be subject to the allocation prohibitions of the rules to the extent they are allocating shares to accounts held with the member firm, and not with its affiliates, particularly offshore affiliates. Many associated persons who work overseas also cover accounts held with offshore affiliates and the prohibitions of the rules should not apply to those accounts not held with member firms.

Furthermore, SIA recommends revising the rule to include a definition of “investment banking business” (or, preferably, “investment banking services” – see our comment above). Firms are already familiar with, and have put into practice, the definition included in the NASD and NYSE research analyst rules. Those rules define investment banking business as “including, without limitation, acting as an underwriter in an offering for an issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPE’s or similar investments; or serving as a placement agent for an issuer.”[7]

[7] See NASD 2711(a)(2).

Additionally, SIA believes that the definition of “material support” is overbroad and should be replaced with the “immediate family member” concept used in the Voluntary Initiative. Underwriters may be able to determine whether an investor has the same name and address as an executive officer or director of a company, but the only basis for reaching any conclusion about material support is a representation from the investor. As discussed above, if the proposed rule takes an approach to defining what relatives of an executive officer or director are covered by the restriction that differs from that taken in the Voluntary Initiative, investors will need to provide their brokers with a separate set of representations that will be both confusing and burdensome. Again, it is difficult to justify placing this additional burden on investors when it is meant to address the exact same set of concerns already addressed in the Voluntary Initiative.

SIA also notes that the proposed rule does not address how often an investor’s status must be checked in order to satisfy the requirements of the rule. We believe that it would be extremely time consuming, inefficient and impractical from the perspective of the underwriter, and burdensome from the perspective of the investor, to require confirmation on a deal-by-deal basis. In fact, deal-by-deal confirmation would likely result in the ineligibility of many investors whose actual eligibility is not in doubt but for an inability to process a deal-specific representation on a timely basis. It would be costly and would potentially reduce the number of investors participating in IPOs and discourage allocations to individual investors.

NASD Rule 2790, which prohibits IPO allocations to certain restricted persons, presents a very similar issue. In that rule, the NASD expressly addressed the issue with a provision requiring member firms to obtain an annual certification from investors, and a statement in the proposal that initial verification of status must be through positive affirmation and subsequent verification may be through negative consent. SIA believes that the proposed rule relating to spinning should include a similar provision. The rule should expressly allow firms to rely on an annual certification from investors, with initial verification by positive affirmation and subsequent verification by negative consent.

Finally, SIA believes that regardless of which form of the spinning rule is ultimately adopted, the SEC should indicate whether the adopted rule replaces the voluntary initiative. Section 6 of the Voluntary initiative states that it shall expire at the earlier of (i) five years from such effective date; or (ii) the effective date of any rule that would place restrictions on the ability of investment banking firms to allocate securities in "hot" IPOs to executive officers and directors of public companies. SIA believes some official pronouncement from the SEC as to the expiration of the Voluntary Initiative would be most helpful.

3. **NASD Rule 2712(c); NYSE 470(C) – Penalty Bids**

The original rule proposed by the SRO’s would prohibit members from penalizing registered representatives whose customers have "flipped" IPO shares that they have purchased through the member, unless a penalty bid, as defined in Rule 101 of Regulation M, has been imposed on the member by the managing underwriter.

SIA expressed support for this provision and the IPO Advisory panel expressed support for the SROs approach.

COMMENT - SIA supports the proposal.

4. **NASD Rule 2712(e)(1) and NYSE Rule 470 (D)(1) – Disclosure of Indications of Interest**

The proposals require disclosure of indications of interest and final allocations to issuer's Board or a pricing committee of the Board.

SIA requested the following minor changes: limit indications to those in the institutional pot, allow firms to present retail indications in aggregate format, leave timing of reports ("regular" requirement) flexible, replace "closing date" with "settlement" date, and impose the rule on underwriters directly rather than do indirectly through the underwriting agreements.

The amended filing incorporates all of these suggestions.

COMMENT - SIA supports the proposal and appreciates the incorporation of SIA's suggestions.

5. **NASD Rule 2712(e)(2); NYSE 470 (D)(2) – Lock up Agreements**.

The original proposal would require that lock-up also apply to issuer directed shares held by officers or directors of the issuer. The proposal would also require the book running lead manager to provide notice of an impending release or waiver of a lock-up to the issuer and an announcement of the same to a major news organization two days prior to release or waiver.

SIA supported both proposals but sought clarification whether the notification provision was intended to apply to a release/waiver of the issuer, the selling shareholder, or both. SIA also suggested that the notification should be two days prior to a sale into the market, not two days prior to a release.

The rule filing clarifies that the notification provision applies to the release/waiver of issuers AND selling shareholders and that the notification requirement would be triggered by the release date, not the eventual sale date. The NASD also dismissed the idea of a *de minimus* standard.

COMMENT - SIA supports the proposal with the qualifications noted in this comment. SIA seeks confirmation that the rule would not require notice to the market two days prior to the release of a lock-up restricting the filing of a registration statement, provided that the release relates solely to a restriction on the filing of a registration statement. Such a release would not involve any release of a restriction on *transfer*. Also, SIA seeks clarification that the (natural) expiration of the lock-up period would not require an announcement. SIA does not believe that such an announcement is necessary because the timing of the expiration of such lock-up would have been effectively disclosed in the IPO prospectus. Finally, SIA seeks clarification that the notice requirement is fulfilled by providing an announcement to a major news organization irrespective of whether the news organization ultimately publishes the announcement. Not all releases will be newsworthy and member firms have no ability to compel a news organization to publish an announcement.

SIA again wishes to emphasize that application of the notice requirement to all lock-up releases strikes us as over-inclusive. In many cases, lock-ups are released for purposes of relatively minor sales or transfers of stock. A shareholder may, for example, request a release in order to transfer shares to a family trust that will agree to be bound by the same lock-up terms that applied to the transferor. A transfer of this type has no impact on the public markets and announcement through a major news service serves no purpose. We continue to believe that the notice requirement should apply only if the release relates to a sale by the issuer or a sale into the market of a material number of shares.

6. **NASD 2712(e)(3); NYSE 470(D)(3) – Returned Shares.**

The original proposal would require underwriters to allot returned shares first to the existing syndicate short position, and then, if there is no syndicate short or the short has already been covered, to permit the underwriter to sell shares in the open market and return any net profits to the issuer. The rule provided that if the market price was not above the offering price, then the underwriter could sell the returned shares at a loss or hold the shares in an investment account.

SIA commented that the rule should only address situations in which the market price exceeds the offering price. SIA also recommended that the issuer would have a better chance of benefiting from the proceeds of returned shares if the rule allowed the underwriter, after first allocating any returned shares to the syndicate short, to *either* allocate those shares to the syndicate short *or* to sell them into the market with the proceeds going to the issuer.

The proposal has been amended by the SROs to require that the underwriter must, after satisfying any syndicate short, offer the returned shares to unfilled customer orders at the offering price through a “random allocation method.”

COMMENT - SIA has expressed support for rules that would provide certainty and clarity with respect to the disposition of returned shares. Unfortunately, these rules do not offer the hoped-for clarity, and in fact, raise more questions than they answer. SIA would like to work with the regulators to craft a rule governing the disposition of returned shares that will provide clear guidance to underwriters. Any rule would need to take into account principles of contract law and the need to address the fact that returned shares can take many forms. For example, shares may be returned because of a mistake by the underwriter that is discovered after the security begins to trade, a mistake by an investor discovered after trading begins, a dispute over whether a contract was ever formed, a refusal by an investor to pay after a contract was formed, an unexplained failure by the customer to settle the trade ("DK"), in which case it can take several days to determine why settlement has not occurred, and operational mix-ups involving incorrect account numbers or wiring instructions.

SIA wishes to reiterate its belief that the rule should only address the situation in which there is a gain in the share price above the offering price. The rationale offered by the IPO Advisory Committee for its recommendation in the IPO Report was the concern that arises when the underwriter has the opportunity to allot returned shares, that have already begun trading *at a premium*, to favored clients. Moreover, it is difficult to envision clients accepting an allocation of shares at the initial offering price if the stock can be purchased more cheaply in the market at the time. Finally, SIA is concerned that a rule focused on returned shares that trade lower will give investors the impression that it is acceptable to walk away from a transaction when shares trade down in the immediate aftermarket. The rule should also clarify how allotment should occur when the number of returned shares is so small as to make random allocation across multiple accounts impracticable. If the number of shares returned is *de minimis*, it should be possible to use a random methodology to identify a single account that will be offered all of the shares. There should in no case be a need to offer any investor an odd lot number of shares.

Any solution requiring (non-manager) syndicate members to return shares to the lead manager is problematic especially if some time has passed since pricing. Currently, each syndicate member deals with DK's and returned shares individually. In one sense, each syndicate member has concluded an agreement to take shares from the syndicate to resell, and there is no recognized procedure for "reopening" that agreement. The proposed rule should not create new opportunities for syndicate members to be able to return shares that they are obligated to place with customers. If adopted, the rule should require firms to have their own individual policies for returned shares, rather than require that shares be returned to the syndicate.

7. NASD 2712(e)(4); NYSE 470 (E) - Prohibition on Market Orders on first day of trading

The original proposal called for a ban on market orders on the first day of trading in an IPO.

SIA opposed the proposal as contrary to the goal of ensuring liquidity in the volatile first days of trading of a new offering. SIA recommended that, if a ban is to be implemented, it should apply to all firms who receive customer orders on the first day of trading, not just those firms who were members of the underwriting syndicate.

The revised rule filing adopts the approach recommended by SIA to extend the rule to all firms, but did not otherwise change the proposal.

COMMENT - The rule proposal raises numerous practical problems.

In a typical opening day market, obtaining an execution could require a customer to submit numerous limit and cancellation orders to get a single execution. This activity may exacerbate volatility in new offerings and hinder proper price discovery, which will add risk and deter investors from purchasing new shares. Alternatively, retail investors who cannot continually monitor intra-day trading may conclude that the only way to secure an execution without using a market order is to submit an order with the highest limit amount that he or she would be willing to pay. In other words, retail investors may intentionally purchase at prices that neither reflect their true investment decision nor their reasonable expectations. If limits are artificially high, the stock price may spike to those high levels and then tumble when the demand at those levels is no longer there. The resulting volatility would make it more difficult for capital markets professionals to maintain a stable aftermarket by making it more difficult to divine where true demand (and accordingly, the true market price) really is.

Furthermore, every firm will incur significant costs obtaining a data feed that is capable of identifying new offerings that are set to begin trading. Our members are not aware of a publicly available data feed that monitors pending IPOs and is capable of signaling when one is set to commence trading. Even if such a product were available, more costs will be expended developing a system that can take this feed and impose a block on all customer market orders in that security. These costs will be particularly onerous for small firms, who are even less likely than big firms to have knowledge that an IPO in which they are not involved has priced. For most small retail firms, building a system to track the progress of all IPOs through the registration process in order to ensure that customers cannot place market orders on the first day of trading will be costly, and these costs may not justify the benefit sought to be achieved.

If the rule is approved, SIA recommends that a regulator should be designated as the official source for informing firms and the market that an IPO has priced.

SEC should clarify that the rule only applies to US-registered IPOs. The rule should not impact a US customer who places a market order for a stock debuting, for example, on the Hong Kong Stock Exchange.

CONCLUSION

The Committee appreciates very much this opportunity to present our views. Should you have any questions, please feel free to communicate with our SIA staff advisor Scott Kursman, Vice President & Associate General Counsel of SIA, at (212) 618-0508. We would be happy to arrange a meeting between the Staff and members of the Capital Markets Committee to explain our views more thoroughly.

Very truly yours,

John Faulkner, Chairman
SIA Capital Markets Committee

cc: Annette L. Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
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