

NYSE/NASD IPO Advisory Committee

Report and Recommendations
of a committee convened by the
New York Stock Exchange, Inc. and NASD
at the request of the
U.S. Securities and Exchange Commission

May 2003

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We are very grateful for the valuable input that the Committee received from Dick Grasso, Chairman and Chief Executive Officer of the NYSE, and Robert R. Glauber, Chairman and Chief Executive Officer of NASD, who actively assisted the Committee in its deliberations. We are also grateful for the support that the Committee received from officers and employees of the NYSE and NASD. In particular, we wish to recognize the assistance we received from Catherine R. Kinney and Robert G. Britz, each of whom is Executive Vice Chairman, President and Co-Chief Operating Officer of the NYSE; Edward A. Kwalwasser, Group Executive Vice President, Regulation, of the NYSE; Richard P. Bernard, Executive Vice President and General Counsel of the NYSE; Mary L. Schapiro, Vice Chairman and President, Regulatory Policy & Oversight, of NASD; Elisse B. Walter, Executive Vice President, Regulatory Policy & Programs, of NASD; Thomas Selman, Senior Vice President, Corporate Finance, of NASD; and Joseph Price, Vice President, Corporate Finance, of NASD. We would also like to recognize James L. Cochrane, Senior Vice President, Strategy & Planning, of the NYSE, and R. Clark Hooper, Executive Vice President, Disclosure Policy and Review, Regulatory Policy and Oversight, of NASD, who facilitated the work of the Committee on behalf of the NYSE and NASD. We further recognize the work of Suzette Crivaro, Noreen M. Culhane, James F. Duffy, Albert Hu, Bryant W. Seaman, Charlotte Smaldone and Robin Weiss, each of the NYSE, and Gary Goldsholle and Andrés Vinelli, each of NASD. Additionally, we wish to thank Andrew J. Nussbaum and Laura E. Muñoz of Wachtell, Lipton, Rosen & Katz, which served as special counsel to the Committee. Finally, we thank the individuals and organizations that gave us their views throughout our review process.

Table of Contents

Introduction	1
Recommendations	4
<i>Promote Transparency in Pricing and Avoid Aftermarket Distortions</i>	4
<i>Eliminate Abusive Allocation Practices</i>	10
<i>Level the Playing Field: Improve the IPO Information Flow and Information Access</i>	14
<i>Improve the Quality of Underwriter Performance and Public Awareness Regarding IPOs</i>	18
Conclusion	20
Appendix A Letter from Harvey L. Pitt	A-1
Appendix B List of Recipients of the Committee's Request for Comments and Presenters to the Committee	B-1

Introduction

Fairness, integrity and efficiency make the U.S. capital markets the most successful in the world. In the past decade, more than 5,600 domestic and foreign enterprises raised an aggregate of over \$500 billion through IPOs in U.S. markets. These IPOs served as an engine for corporate growth and active participation by all sectors of the investment community, from venture capitalists to large institutions and individual investors.

In recent years, however, public confidence in the integrity of the IPO process has eroded significantly. Investigations have revealed that certain underwriters and other participants in IPOs at times engaged in misconduct contrary to the best interests of investors and our markets; at least some of this misconduct was unlawful. Instances of this behavior became more frequent during the IPO “bubble” of the late 1990s and 2000, a period in which an unusually large number of offerings traded at extraordinary and immediate aftermarket premiums. These large first-day price increases in turn affected the allocation process by creating a pool of instant profits for underwriters to distribute. Some did so improperly — in exchange for a share of these profits, or perhaps for a promise of future business. In turn, some institutional investors were willing to participate in improper arrangements in order to receive the essentially guaranteed profit that “hot” IPOs came to represent. Among the most harmful practices that have given rise to public concern are:¹

- “*Spinning*”: Certain underwriters allocated “hot” IPO shares to directors and/or executives of potential investment banking clients in exchange for investment banking business.

¹ These practices have arisen in the context of the “bookbuilding” IPO, which is the predominant method for conducting IPOs in the United States and worldwide. This is not to imply, however, that the bookbuilding process is inherently flawed or that it is inferior to other methods for conducting an IPO. The Committee believes that the capital markets, and not regulators, should determine the most desirable method for bringing a company public.

- *Artificial Inflation of Aftermarket Prices:* Some underwriters engaged in inequitable or unlawful tactics to support aftermarket prices and boost aftermarket demand. These included, for example, (1) allocating IPO shares based on a potential investor's commitment to purchase additional shares in the aftermarket at specified prices and (2) imposing penalties on retail brokers in connection with immediate "flipping" by retail IPO investors but not by other categories of IPO participants (such as institutions).
- *Unlawful Quid Pro Quo Arrangements:* Underwriters unlawfully allocated IPO shares based on a potential investor's agreement to pay excessive commissions on trades of unrelated securities.
- *Biased Recommendations by Research Analysts:* With their compensation and promotion tied to the success of their firms' investment banking business, some research analysts apparently agreed to issue and maintain "buy" recommendations on certain stocks despite aftermarket prices that jumped to multiples of their IPO prices.

Exacerbating the loss of confidence in our IPO process is the widespread perception that IPOs are parceled out disproportionately to a few, favored investors, be they large institutions, powerful individuals or "friends and family" of the issuer.

The New York Stock Exchange, Inc. (the "NYSE") and NASD (together, the "SROs") convened this Committee at the request of Harvey L. Pitt, then-Chairman of the U.S. Securities and Exchange Commission (the "SEC"), to "review the IPO underwriting process, particularly price setting and allocation practices, in light of recent experience, and to recommend to the securities industry community such changes as may be necessary to address the problems that have been observed."² As part of its review, the Committee evaluated input from a cross-section of the investment

² The letter from Harvey L. Pitt to the NYSE and NASD is included as Appendix A to this Report.

and academic community.³ In fulfilling our mandate, we did not endeavor to mirror the efforts, or assume the role, of regulatory enforcement authorities. Rather, we examined and evaluated the entire IPO process from the perspective of its various participants.

Our 20 recommendations follow four basic themes:

- (1) The IPO process must promote transparency in pricing and avoid aftermarket distortions.**
- (2) Abusive allocation practices must be eliminated.**
- (3) Regulators must improve the flow of, and access to, information regarding IPOs.**
- (4) Regulators must encourage underwriters to maintain the highest possible standards, establish issuer education programs regarding the IPO process and promote investor education about the advantages and risks of IPO investing.**

Our proposals complement various legislative and regulatory initiatives, including the announced Global Settlement among regulators and major investment banks,⁴ the Sarbanes-Oxley Act of 2002 and related SEC rules, new SRO rules dealing with analyst conflicts, proposed NASD rules regarding activities of registered representatives and pending NYSE and Nasdaq rules relating to corporate governance.

³ A list of entities and individuals from whom the Committee solicited and/or received comments is included as Appendix B to this Report.

⁴ The Committee was convened amidst a wave of news reports and regulatory investigations concerning allegedly unlawful interactions between underwriters' research and investment banking divisions. The general terms of an agreement for a Global Settlement among major investment banks, the SEC, the New York Attorney General, the NYSE, NASD, the North American Securities Administrators Association and state regulators were announced in December 2002. On April 28, 2003, regulators announced that enforcement actions against the major investment banks had been completed, thereby finalizing the Global Settlement. Because of the pendency of these matters, the Committee did not address issues of analyst research or conflicts of interest, and the Committee's recommendations do not cover this area.

Recommendations

Promote Transparency in Pricing and Avoid Aftermarket Distortions

Dramatic and immediate run-ups of IPO prices in the immediate aftermarket — particularly during the bubble period of the late 1990s and 2000 — greatly undercut investor confidence in the integrity of the pricing process. These price increases created an immediate profit for the fortunate few who received these “hot” IPO allocations, and thus provided the impetus, or at least set the stage, for much of the abusive behavior that occurred. Although we do not base our recommendations solely on the experiences of the bubble period, the abusive behavior during those years highlights the need to increase the transparency of the IPO pricing process and to prevent aftermarket distortions that exacerbate mispricing.⁵

1. **Require each issuer to establish an IPO pricing committee of its board of directors — including at least one director who is independent of management (if any director qualifies) — to oversee the pricing process.**

The pricing of an IPO is a business decision reached by the issuer in consultation with the underwriter. In making this determination, the issuer’s directors and management have a fiduciary duty to act in the best interests of the corporation and its shareholders. It is the board’s responsibility to use its good faith business judgment when disposing of the issuer’s assets, including its capital stock in an IPO. This involves directors and

⁵ A number of presenters expressed to the Committee a belief that the immediate and dramatic price increases of some IPOs during the bubble period “proved” that those IPOs were deliberately underpriced and, as a result, that the issuers of those shares were misled, and perhaps even cheated out of a “fair” price. Others expressed a different view, arguing that the subsequent dramatic declines in the price of many of these bubble period IPOs (in many cases to zero) indicates that these shares were in fact overpriced. The Committee’s mandate was not to engage in this debate but rather to propose forward-looking reforms to eliminate the potential for future abuse. Hence, our recommendations do not assume that bubble period IPOs were deliberately underpriced to the detriment of issuers.

management weighing key considerations regarding the transaction, including the long-term implications of various IPO pricing scenarios.

Consistent with these obligations, some issuers as a matter of good practice establish a pricing committee of the board to monitor developments in, and make key decisions regarding, the IPO, or involve the full board in the process. SROs should require all prospective issuers to follow this practice. The pricing committee's responsibilities should include receiving periodic updates from the underwriters and management, reviewing the IPO order book during the marketing period and making the final pricing decision (or recommendation to the full board), as well as reviewing the final allocation of shares. The SROs should encourage open and frequent dialogue between the issuer's pricing committee and the underwriter, especially on topics of pricing and allocation.

The pricing committee should include at least one director who is independent of management if any director qualifies as such.

2. Require underwriters to provide to the issuer's pricing committee all indications of interest before the issuer determines the IPO price.

A key component of the underwriter's pricing recommendation, and therefore of the issuer's pricing decision, is understanding investors' demand for the offering at different price levels, as demonstrated by the indications of interest that the underwriter's team gathers during the marketing period. SROs should require underwriters to share this information with the issuer in a timely manner. We encourage underwriters to engage in an open discussion with the issuer's pricing committee, explaining to the issuer the context and significance of indications of interest from various investors, as well as sharing their perspective on this demand.

3. Redress and prevent prohibited IPO laddering.

Collecting information about investors' long-term interest in, and valuation of, a prospective issuer is an essential part of the bookbuilding process. However, Regulation M and the general anti-fraud and anti-manipulation provisions of the federal securities laws prohibit underwriters, while engaged in the bookbuilding process, from attempting to induce purchases in the aftermarket for IPO shares. The term "laddering" has been used to describe one form of this prohibited conduct, namely, inducing investors to give orders to purchase shares in the aftermarket at particular prices in exchange for receiving IPO allocations. This conduct distorts the offering and the aftermarket and impairs investor confidence in the IPO process. We encourage the SEC and SROs to take appropriate measures to redress and prevent this harmful conduct. We also encourage underwriters, in consultation with the regulators, to develop effective internal policies and procedures to prevent prohibited secondary market activity.

4. Prohibit, for the first trading day following the IPO, the placing of unpriced orders to purchase an issuer's shares.

IPO issues are inherently more volatile than stocks with a public trading history. For this reason, initial market orders — orders to purchase "at any price" placed in the early minutes or hours of the IPO's launch — are particularly troublesome. Such orders may result in purchases by individual investors at prices that reflect neither their true investment decisions nor their reasonable expectations. Disallowing orders without a price cap for the first trading day following an IPO will allow the market to develop some trading information, thereby making subsequent uncapped orders more appropriate.

During this initial period, investors would continue to be permitted to place limit orders (*i.e.*, orders that specify a maximum purchase price). Limit orders at prices substantially above the IPO price, however, may in effect amount to market orders; for this reason, brokers should pay special attention to the "know your customer" obligations and suitability rules that govern their day-to-day practices.

5. Prohibit the inequitable imposition of “flipping” penalties.

Current SEC and SRO rules generally permit underwriters to impose penalty bids on syndicate members. A penalty bid permits the managing underwriter to reclaim a selling concession from a syndicate member if the syndicate member's customers sell the IPO shares originally allocated to them shortly after the IPO, a practice known as “flipping.” Penalty bids are intended to promote the development of a stable aftermarket.

In cases where penalty bids have not been imposed on syndicate members, individual members apparently have imposed penalties on individual brokers in connection with flipping by the broker's small retail customers, while not imposing penalties in connection with flipping by other categories of IPO participants. In some instances, individual syndicate members have made clear to retail brokers that they will be penalized, through withdrawn commissions or otherwise, and possibly excluded from future IPO allocations, if their retail clients show a high level of flipping activity. Faced with these potential penalties, brokers in turn may discourage their retail customers from immediately selling their IPO shares.

The SEC and the SROs should address this discrimination by requiring that in the absence of a penalty bid on a syndicate member, that member may not impose penalties on a retail broker or investor. A possible approach is proposed NASD Rule 2712(d), which would prohibit underwriters from imposing a flipping penalty upon a registered representative in connection with a sale to a retail investor unless a penalty bid has been imposed on the entire underwriting syndicate in connection with sales to all participants in the IPO.

6. Establish clear parameters for underwriters' sales of returned shares after secondary market trading has commenced.

IPO shares are sometimes returned to the underwriter after secondary trading commences, due to factors such as mistaken allocations, incomplete information or other problems relating to

the delivery of shares or the settlement of trades. If IPO shares trade at an immediate aftermarket premium, the underwriter is in a position to allocate any returned shares to favored customers at the IPO price, thus unfairly granting these customers the opportunity to collect an immediate profit. Although recipients of “hot” IPO allocations may be unlikely to return shares to the underwriter, it is imperative that we eliminate any opportunity for abuse that may arise as a result of returned “hot” IPO shares.

SROs should require that IPO shares that are returned to the underwriter for any reason (including failed settlements or failed trades) first be allotted to reducing any existing syndicate short position. SROs should further provide that underwriters must sell the remaining returned shares on the open market and return any net profits on such sales to the issuer. Where the market price does not rise above the offering price, the underwriter should be permitted to sell the shares for its account or retain the shares by placing them in its investment account.

- 7. Raise the SEC’s threshold requirement for amendment to the prospectus from 20% to 40% in cases of increases to the offering price or number of shares offered.**

Regulatory impediments to accurate pricing of IPOs should be as few as possible. Under current SEC rules, issuers often must amend their registration statement or file a new registration statement not eligible for immediate effectiveness when the number of shares to be offered or the offering price in the aggregate change by more than 20%. These rules can operate to discourage increases to the offering price or number of shares offered in excess of 20%, since issuers generally avoid risking the possibility of even a short delay that could result from the SEC filing process. A late-stage increase in proceeds essentially indicates a significant level of excess investor demand at the prior price. Issuers and the investing public would be well served by more flexibility in upward adjustments, such as an increase to 40% from 20%, to address this excess demand. Any amended or supplemental filing should be immediately effective, without the need for SEC staff review and without the need to delay the offering unless the increase results in a material change in the

prospectus disclosure beyond that related to price or number of shares offered.

We do not recommend a comparable change in the case of decreases to the aggregate offering price or shares offered because of the possible greater materiality of these changes to other disclosure.

8. Eliminate regulatory impediments to the development of alternatives to bookbuilding.

In recent years, alternatives to bookbuilding — most notably Dutch auctions — have emerged in the United States. In a Dutch auction, pricing and allocation are removed from the realm of issuer and underwriter discretion. Investors express their interest level and price threshold, and the offering price is set at the highest level at which all of the shares to be offered can be sold. IPOs conducted through a true auction model should not experience the enormous aftermarket price spikes that fueled the abuses of the bubble period. The final IPO price in an auction represents, or is at least close to, the maximum price that the market is willing to pay for the issuer's security.

The market, and not regulators, should determine whether bookbuilding, a Dutch auction or another method is desirable for a particular IPO. The SEC and the SROs should review their rules with a view to addressing provisions that may impede the use of such alternative pricing methods. The SEC has already expended considerable effort to accommodate its rules to the Dutch auction process. A further clarification that the SEC should consider is to eliminate an underwriter's obligation to reconfirm an offer outside the initial price range from a bidder who has already indicated a willingness to purchase at a higher price.

Eliminate Abusive Allocation Practices

Underwriters face competing objectives and conflicting interests in allocating IPO shares. The issuer generally desires that shares be placed with long-term investors. On the other hand, the availability of an aftermarket for the stock is part of the inducement to participate in the IPO. By definition, however, trading requires that there be a first seller. Finally, underwriters may desire to allocate at least some shares to their best customers in order to maintain client relationships. As we describe below, greater transparency in, and further rulemaking regarding, the allocation process will help ensure a proper balance of these competing objectives and a fair resolution of these conflicting interests.

9. **Prohibit the allocation of IPO shares (1) to executive officers and directors (and their immediate families) of companies that have an investment banking relationship with the underwriter, or (2) as a quid pro quo for investment banking business.**

The SEC and the SROs should impose a clear prohibition on spinning — *i.e.*, an underwriter's allocation of IPO shares to directors or executives of investment banking clients in exchange for receipt of investment banking business. Regulators should similarly restrict conduct that may be viewed as or evolve into spinning.

Existing and proposed NASD rules provide a starting point. Proposed NASD Rule 2712 would, among other things, prohibit an underwriter from allocating IPO shares (1) to an executive officer or director of a company on the condition that the officer or director send the company's investment banking business to the underwriter, or (2) as consideration for investment banking services previously rendered. In addition, NASD's free-riding and withholding interpretation generally imposes restrictions on allocations of "hot issues" to money managers, such as venture capitalists and hedge fund managers, who are in a position to direct business to a broker-dealer. NASD's proposed Rule 2790 (which would replace the free-riding and withholding

interpretation) imposes additional restrictions on such persons by, for example, eliminating an investment bank's ability to allocate IPOs to such persons even if such allocations are consistent with the person's "normal investment practice."

These proposed spinning restrictions should be expanded to include selected affiliates of an executive officer or director, such as members of the covered person's immediate family. In addition, the very existence of an investment banking relationship should bar all directors and executive officers of the underwriter's investment banking client from receiving any IPO shares from the underwriter. There is no escaping the appearance of impropriety in these situations, especially in light of the highly publicized abuses that occurred during the bubble period. Furthermore, we encourage the SEC and SROs to consider if and to what extent the existence of a previous investment banking relationship should trigger similar restrictions on allocations to directors and executive officers.

The Committee completed its deliberations prior to the announcement of the Global Settlement. In connection with the Global Settlement, the ten settling firms entered into a voluntary initiative regarding spinning. This voluntary initiative includes a comprehensive ban on allocations of "hot" IPO securities to executive officers and directors of public companies and a restriction on participation of investment banking personnel in allocation decisions. The Committee did not have the benefit of this initiative when it formulated its recommendations. The voluntary initiative should also be considered by the SROs and the SEC in connection with their future rulemaking activities in this area.

10. Provide that a listed company's code of business conduct and ethics should include a policy regarding receipt of IPO shares by the company's directors and executive officers.

All companies should reexamine their corporate governance policies and procedures regarding the receipt of IPO shares by their directors and executive officers. Even if these allocations do not violate applicable law, they have generated significant investor

skepticism with respect to these individuals' loyalty to shareholders.

Although our proposed ban on spinning would prohibit a wide range of potential misconduct, the burden should not fall exclusively on the underwriters and SROs. Issuers and their boards should provide investors with comfort that IPO allocations do not unduly interfere with the fulfillment of directors' and officers' fiduciary duties. Thus, each listed company's required code of business conduct and ethics should include a policy regarding these IPO allocations.

Companies should carefully examine whether to take affirmative steps to limit or prohibit practices that may be characterized as spinning. Such steps may take the form of a company pre-approval policy regarding the purchase of IPO shares by the company's directors and officers, or a complete ban on such practices.

We hope that companies and institutions that are not bound by SRO corporate governance standards will similarly evaluate their policies regarding potential spinning practices. In that regard, we note that the National Venture Capital Association recommends that its members adopt a code of ethics regarding receipt of IPO allocations by general partners and employees of venture capital organizations. We also recommend that federal, state and local jurisdictions consider whether restrictions or pre-approval policies would be appropriate with respect to IPO allocations to elected officials and political appointees.

11. Strengthen existing prohibitions on unlawful quid pro quo allocations.

SEC and SRO rules prohibit an underwriter's allocation of IPO shares based on the recipient's agreement to "kick back" to the underwriter, either through excess commissions or otherwise, a portion of the flipping profits. We fully support this aspect of proposed NASD Rule 2712, which would add a more explicit restriction by specifically prohibiting the allocation of IPO shares

as consideration or inducement for the payment of excessive compensation for other services provided by the underwriter.

Our recommendation, however, is in no way intended to restrict the underwriter's lawful exercise of its allocation discretion or to interfere with legitimate relationships between an underwriter and its customers. Unless such an allocation constitutes spinning, an unlawful quid pro quo or other prohibited conduct, the underwriter may allocate IPO shares to customers as it chooses, including to its retail and institutional clients.

12. Impose substantive limits on issuers' "friends and family" programs.

An IPO often includes an issuer-directed allocation of a portion of the offering. This portion of the offering may be used to permit company employees to invest in their employer at the IPO price, or to permit strategic business partners to have a small investment in the issuer. Historically, these "friends and family" programs represented two to three percent of the IPO offering. During the bubble period, the size of these programs at times increased to over ten percent of the offering. When misused or overused, an issuer's "friends and family" program may compromise the IPO process. The SEC and the SROs should establish reasonable parameters for the fair use of issuer directed share programs by:

- imposing a five percent maximum size for an issuer's directed share program; and
- requiring that any lock-up that applies to shares owned by officers and directors include the shares purchased by those individuals in the "friends and family" program.

Level the Playing Field: Improve the IPO Information Flow and Information Access

The SEC and SROs should foster clearer channels of communication among the underwriter, the issuer and the general investment community. All investors should have sufficient access to information to allow them to make informed investment decisions about an IPO. Moreover, the exchange of information between the underwriter and the issuer should be characterized by transparency, not opaqueness.⁶

13. Require issuers to make a version of their IPO roadshow available electronically to unrestricted audiences.

Roadshows have traditionally been considered a key opportunity for large, primarily institutional, investors to gather additional information about IPO issuers, enjoy face-to-face exposure to senior management and learn management's view of the most important aspects of the company and the offering. Issuers and underwriters place great emphasis on roadshows, since roadshow attendees will likely constitute the bulk of the issuer's shareholder base once the company has gone public. Many large investors will not participate in IPOs unless they are provided an opportunity to meet and evaluate management during the roadshow.

Under the current regulatory scheme, the SEC considers roadshows (including any slides used as part of the roadshow presentation) to be permitted oral communications under the Securities Act of 1933 (the "Securities Act"), provided that no written materials are distributed to attendees. An electronic or broadcast transmission, however, raises concerns regarding "written" offers under existing SEC interpretations and therefore is

⁶ In addition to the recommendations outlined below, three members of the Committee would further recommend that issuers that provide projections of future earnings to any investor be required to include such projections in the prospectus, provided that there is a statutory safe harbor to address liability concerns. Furthermore, two members of the Committee would require additional prospectus disclosure by the underwriters where IPO allocations are based in whole or in part on commissions earned by the underwriting firms.

allowed during the offering period only pursuant to significant conditions established by the SEC staff in “no-action” letters. Thus, electronic roadshows often are not made available to retail investors.

The reliance on oral roadshow presentations, coupled with selective attendance at roadshows, creates a disparity in information that may disadvantage retail investors as well as other potential investors who may not be able, or are not invited, to attend the roadshow. Whether or not there is an actual disadvantage, there is a strong perception that critical information is communicated to institutional investors at roadshows and is not included in the prospectus for the benefit of other investors. This information may include, for example, management’s explanation of its enthusiasm for the company’s prospects. Indeed, even the opportunity to see and hear senior management may provide significant information for an investment decision. Many potential investors, both in the IPO and in the aftermarket, having been excluded from the roadshow, are not privy to this information. To dispel the perception of unfairness, this must change.

Technological developments can now help bridge the information gap by allowing the general investment community to access electronically an audio or video playback of a roadshow. The SEC should amend current rule interpretations to state affirmatively that electronic roadshows, although subject to the general anti-fraud provisions of the securities laws, are permissible offers under the Securities Act, thus enabling wide access to these presentations. The SEC should also require that any issuer that elects to use a roadshow as part of its marketing of the offering post the roadshow on its website, accompanied by a web link to the prospectus, or otherwise make the roadshow widely accessible without charge. To preserve the importance of the prospectus and full investor disclosure, the electronic roadshow should be required to contain a link to the available prospectus, an appropriate notice to viewers that an offer of the issuer’s securities may only be made through a prospectus and advice to read the full prospectus before indicating an interest in the offered securities.

14. Require that the underwriter disclose the final IPO allocations to the issuer.

In the traditional bookbuilding IPO, the underwriter which serves as bookrunner retains the discretion to determine the final IPO share allocations. Nevertheless, to assure trust in the allocation decision process, the SROs should require, subject to any applicable financial privacy limitations, that the managing underwriter disclose and explain to the issuer the final allocation of its IPO shares.

Sharing the final allocation information with the issuer will also help the issuer evaluate this aspect of the bookrunner's performance, which may be an important consideration for the issuer when embarking on any future capital-raising transaction.

15. Require that the prospectus include a clear description of lock-up agreements and of whether the underwriter expects to grant exceptions relating to hedging or other transactions.

Underwriters routinely require directors, officers and certain pre-IPO shareholders of an issuer to enter into lock-up agreements that restrict their sale of company shares for a specified period, typically six months. These lock-up agreements usually contain certain exceptions and may be waived in whole or part by the lead underwriter in its discretion.

Lock-up agreements are disclosed in broad terms in the prospectus and are often highlighted during the marketing process. Ending, or granting exceptions to, previously disclosed lock-up agreements is at least as material to shareholders as the initial agreement. Prospective investors should be more fully informed of the terms of all lock-up agreements between the underwriter and the covered persons, including whether the lock-ups permit the effective hedging or collaring of the locked-up shares without the underwriter's consent. Any preexisting plans by the underwriter to exempt a director or officer from a lock-up agreement should also be disclosed.

16. Reiterate existing requirements that all collars and other custom derivatives relating to initial insider holdings be promptly filed electronically with the SEC on Form 4.

Underwriters or other investment bankers may make available to an issuer's directors and executives various transactions relating to their locked-up securities. These generally take the form of collars and other types of derivative contracts. Any such transaction that has occurred shortly following an IPO constitutes important market information that should be readily accessible to all investors.

Under current SEC rules, company directors, executive officers and large shareholders must report transactions in the issuer's securities on Form 4 within two business days of completion of the transaction. All collars and derivative contracts relating to a director's or an officer's shares in an issuer are reportable on Form 4 as "derivative securities." The SEC should consider whether additional clarification or other measures are needed to reinforce these rules.

17. Require improved disclosure regarding exemptions by an underwriter to an IPO lock-up agreement. Specifically:

- **Require that underwriters notify issuers prior to granting any exemption to a lock-up, and require issuers to file a current report on Form 8-K at least one business day prior to the time the insider commences the transaction.**
- **Require that, prior to the transaction, the lead underwriter announce the exemption by broad communication to the investment community through a major news service.**

As noted above, lock-ups are an important part of the IPO marketing process. Investors should be made aware in a timely manner of any development that would counter the established expectation that the issuer's directors, officers and large pre-IPO

shareholders who entered into lock-ups will be bound by them for the stated period. Underwriters should communicate this information to investors through announcements on a major news service. These pre-transaction disclosure requirements will ensure that the market has the information at the appropriate time, not after the sale by the executive.

18. Require more complete prospectus disclosure about the nature and size of the issuer's "friends and family" program.

Although current rules impose certain disclosure requirements with respect to directed share programs, the SEC should promote greater transparency by requiring a more detailed description of the issuer's "friends and family" program. Possible additional categories for disclosure include the total size of the program, the number of individuals or institutions who participated, the largest, smallest and average purchase under the program, the minimum percentage being allocated to employees, the categories of recipients and allocations to participants that exceed a specified threshold.

Improve the Quality of Underwriter Performance and Public Awareness Regarding IPOs

While the foregoing measures should greatly improve the transparency and fairness of the IPO process, the basic and most essential ingredients to ensure the integrity of IPOs are an issuer's awareness and discharge of its obligations in the IPO context, an underwriter's ethical and fair performance of its duties and the participation of an informed investing public that understands the inherent volatility in the IPO market and the risks of IPO investing. To this end, we recommend measures to promote underwriter standards and to educate issuers and investors.

19. Impose additional requirements to promote the highest standards of conduct for underwriters, including:

- enhanced periodic internal review by the underwriter of its IPO supervisory procedures; and
- a heightened focus on the IPO process in SRO examinations for investment banking personnel.

These steps would emphasize to underwriters the importance of a high level of diligence and an awareness of the underwriting team's obligations under the securities laws and SRO regulations in the context of an IPO. In this regard, boards and senior management of underwriting firms should reinforce, through continuing education and internal policies, the need for high standards of integrity, ethical conduct and professional responsibility when serving as an underwriter of an IPO.

20. Launch an education campaign for new issuers and IPO investors.

The SEC and the SROs should establish educational and information programs for new issuers. Such programs could provide prospective issuers with an overview of the IPO process and the rules applicable to it, the different types of IPOs available to issuers, and the issuer's responsibilities once the company has gone public.

Although a focus of the Committee's deliberations and recommendations has been "leveling the playing field" between institutional and retail investors, this does not mean that, even with our reforms, IPOs are suitable for all investors. Retail investors need to better understand the inherent risks in IPO investing, and may require education in how to read prospectuses and evaluate roadshow materials. It is therefore essential that the SEC and the SROs promote ways to educate investors as to the potential benefits and disadvantages of IPO investing, including through the dissemination of historical information regarding returns on IPOs over time as compared to returns on stocks with

longer trading histories. SROs should emphasize to broker-dealers that, consistent with their “know-your-customer” obligations, these institutions should also participate in efforts to educate the retail investor. Investors should be encouraged to regard IPOs not as products in and of themselves (potentially giving rise to immediate profits upon flipping), but rather as an opportunity to participate in the long-term growth of the specific enterprise issuing the shares. In short, fair access must be coupled with education.

Conclusion

The IPO process is critical to the success of the U.S. capital markets and to innovation in our economy. It is imperative that IPOs remain an effective way for companies to have meaningful access to capital for growth, and for investors throughout the world who are willing to accept the risks and rewards of participating in the capitalization of new companies to have an opportunity to make an informed investment decision. We have designed our recommendations to safeguard the integrity, transparency and efficiency of our IPO process, and thereby to restore investor confidence in that process.

Appendix A



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

August 22, 2002

Mr. Richard Grasso
Chairman and Chief
Executive Officer
The New York Stock
Exchange, Inc.
11 Wall Street
New York, New York 10005

Mr. Robert R. Glauber
Chairman and Chief
Executive Officer
NASDAQ
1735 K Street, NW
Washington, DC 20006

Dear Dick and Bob:

I am writing to ask you jointly to convene a high level group of business and academic leaders to review the initial public offering (IPO) process in light of the experience of the 1990s and to recommend ways to address the problems evidenced during that period and to improve the underwriting process.

As you know, IPO prices often soared after the initial offering, in some cases as much as 700 percent on the first day. Hot IPOs were heavily oversubscribed, and many investors were frustrated in their attempts to participate in the IPOs. Participation in these IPOs became immensely valuable for both underwriters and customers, inducing aggressive conduct to gain this business. As a result, serious questions arose about the price setting process and the allocation practices of the underwriters of some of these offerings. For example, to obtain IPO allocations, some investors paid excessive commissions, or may have been induced to

purchase shares in the aftermarket, distorting the market for these securities. In other cases, hot IPO shares may have been allocated to individuals for the purpose of obtaining investment banking business.

The Commission and the securities self regulatory organizations continue to investigate possible violations of existing rules, and are also working together to address issues regarding the role of securities analysts in the offering process. The SROs are also in the process of considering additional rulemaking concerning IPO allocations and distributions. The Commission nevertheless believes that the U.S. securities markets would benefit from a broader review of the IPO offering process to evaluate whether changes are needed to existing rules and statutes, and whether additional rulemaking currently contemplated will be sufficient to strengthen the integrity of this offering process and better protect investors. This review necessarily must include both the issuers' and the underwriters' role in the price setting and offering process.

For this reason, we believe that it would be desirable for you to convene a committee of distinguished representatives of issuers, underwriters, investors, academics, and other market participants to review the IPO underwriting process, particularly price setting and allocation practices, in light of recent experience, and to recommend to the securities industry community such changes as may be necessary to address the problems that have been observed. As SROs, you could help inform this committee about offering practices through gathering information from your members who act as underwriters. The Commission would take the greatest interest in its deliberations and conclusions.

Thank you in advance for your efforts. If we can be of any assistance to you, please do not hesitate to let us know.

Yours truly,

/s/ Harvey L. Pitt
Harvey L. Pitt

Appendix B

The Committee solicited and/or received comments from the following individuals and entities:

Prof. Reena Aggarwal,
McDonough School of
Business, Georgetown
University

American Council for Capital
Formation

American Federation of Labor
and Congress of Industrial
Organizations

Association for Investment
Management and Research

Association of Publicly Traded
Companies

August Capital

Prof. Lawrence M. Ausubel,
Department of Economics,
University of Maryland

The Business Roundtable

CIT Group Inc.

California Public Employees'
Retirement System

The Carlyle Group Inc.

The Conference Board Inc.

Consumer Federation of
America

Council of Institutional
Investors

Cumberland Associates LLC

Fidelity Management &
Research Company

Financial Executives International

Mr. Peter Frishauf

Georgeson Shareholder
Communications, Inc.

Goldman, Sachs & Co.

Ms. Wendy L. Gramm, Director,
Regulatory Studies Program,
Mercatus Center at
George Mason University

Prof. Robert S. Hansen,
A.B. Freeman School of
Business, Tulane University

Institutional Shareholder
Services, Inc.

Investment Company Institute

Prof. Donald C. Langevoort,
Georgetown University
Law Center

Lehman Brothers Inc.

Prof. Alexander Ljungqvist,
Leonard N. Stern School of
Business, New York University

Merrill Lynch & Co., Inc.

National Association of Investors
Corporation

National Association of Small
Business Investment Companies

National Venture Capital
Association

Needham & Company, Inc.

New Enterprise Associates

Public Employees
Retirement System of Ohio

Renaissance Capital
Corporation

Securities Industry Association

TIAA-CREF

Tiedemann Investment Group

Prof. Gregory F. Udell,
Kelley School of Business,
Indiana University

Venrock Associates

Welsh, Carson, Anderson & Stowe

Prof. William J. Wilhelm, Jr.,
McIntire School of Commerce,
University of Virginia

William Blair & Company

Prof. Kent L. Womack,
Tuck School of Business,
Dartmouth College

New York Stock Exchange, Inc.
11 Wall Street
New York, NY 10005
(212) 656-3000
www.nyse.com

NASD
1735 K Street, NW
Washington, DC 20006
(202) 728-8000
www.nasd.com